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Introduction to

Business

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CHAPTER 1

The business world and business management

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The purpose of this chapter

This chapter discusses the role of business in society and explains how a business organisation in a market economy employs the various resources of a nation (its natural resources, human resources, financial resources and entrepreneurship) in order to satisfy the need for products and services. The chapter gives an overview of the prevailing economic systems in the world and explains how the business organisation functions in a market economy.

Learning outcomes

On completion of this chapter you should be able to:

- explain the role the business organisation plays in making available the products and services society must have to exist and thrive
- describe the needs of society and how a business organisation satisfies those needs in a market economy
- distinguish between the world's three main economic systems
- explain the interface between a business organisation and a market economy
- describe the nature and purpose of business management as a science, where the enabling factors, methods and principles of the business are studied to ensure the efficient functioning of a business organisation
- comment on the development of business management as a science
- distinguish between and comment on the different management functions.

1.1 Introduction

In a market economy, the business world can be seen as a complex system that involves transforming resources into products and services. These products and services must meet the needs of people in exchange for a profit. This description of business emphasises four different elements:

- human activities
- production
- exchange
- profit.

These elements are discussed in detail in section 1.2, but first consider the case study below. As the case study illustrates, the **profit** of a business is dependent on their ability to efficiently deliver goods and services that society needs. However, where the management of the organisation fails, and it is further influenced by players and factors outside of their direct control, such as regulators and customers, it can lead to

disastrous consequences. Businesses also have to trade off the demands of divergent **stakeholders**, such as employees, government, regulators and suppliers to strive for **sustainability** and the best interests of the society they serve.

CASE STUDY: PRASA ON THE BRINK OF COLLAPSE [1]

The urban passenger rail services operated by the Passenger Rail Agency of South Africa (Prasa) have long been a backbone of the urban transport system, transporting millions of workers to and from their workplaces every day. But by 2018, Prasa was reported to be on the brink of financial collapse, and it was losing commuters who had lost confidence in its ability to deliver on its core mandate of providing an efficient, safe and timeous urban train service.

The continued decline in operating performance by the rail unit has shown a corresponding effect on passenger patronage which dropped to 372 million passenger trips per annum, against 448 million passenger trips the previous year, negatively impacting on Prasa's fare revenue and contributing to a loss of R928 million, up from a R554 million loss the previous year.

Prasa's acting CEO, Sibusiso Sithole, said the rail division's disappointing performance, where only 33 per cent of its targets were achieved, posed a serious challenge in positioning rail as the mode of choice for the commuting public. In fact, commuters were so frustrated that they often reverted to violence, burning train carriages and further crippling the Prasa fleet.

Prasa's problems did not end there. Fruitless and wasteful expenditure incurred stood at R988 million for Prasa and R992,2 million for the group, pointing to the governance problems facing the entity. It was also facing a clampdown from the Railway Safety Regulator (RSR) due to not meeting safety conditions and even operating without a safety permit at one point. To add to its woes, the theft and vandalism of cables and components aggravated the challenges of maintenance, resulting in increased numbers of rolling stock unavailability and unreliability. This negatively affected the delivery of a safe, clean and secure train service.

The board of Prasa faces a difficult challenge, and needs to urgently attend to the uncertainty relating to the growing concern by ensuring financial viability and sustainability of the agency, and addressing the governance and leadership instability characterising it.

1.2The role of business in society

The **business world** is a complex system of individuals and business organisations that, in a market economy, involves the activity of transforming resources into products and services in order to meet peoples' needs. These products and services are offered to the market in exchange for profit. This description of business emphasises four different elements:

- Firstly, business involves human activities. Business organisations are managed by people. While businesses may own property, machines and money, all of these are managed or operated by people.
- Secondly, business involves production. Production is the **transformation** of certain **resources** into products and services, as illustrated in Figure 1.1. This may be, for example, the conversion of flour, sugar and butter into bread, or the conversion of bricks, sand, cement, wood and steel into a house. Even services are produced. For example, in a hospital, beds and medicine are converted into a health service. An airline transports passengers to their required destinations, and as this happens, the passengers become part of the transformation process.
- Thirdly, business involves exchange. Businesses produce products and services, not for their own use, but to exchange for money or for other products and services.

•Finally, business involves profit. Few individuals or business organisations can continue producing products and services without earning a profit. Profit is the reward for meeting people's needs, and it enables businesses to pay for resources and to make a living. However, profit has to be earned in a way that is fair and sustainable, and that is why the board of Prasa finds itself in the precarious position of trying to turn around a business facing challenges on many fronts.

Figure 1.1: How entrepreneurs transform a nation's resources into products and services

Some businesses produce predominantly tangible products such as bread, cars, houses or bicycles. Other businesses produce predominantly services such as entertainment, communication, insurance or transport.

Business is the means by which society endeavours to satisfy its needs and improve its standard of living by creating wealth. At the heart of all business activity are entrepreneurs, who start new ventures and thereby create jobs, economic growth and, hopefully, prosperity. No one invented the business world. It is the result of activities related to meeting the needs of people in a market economy.

The most important characteristic of the business world in the developed countries of the West and Asia is the freedom of individuals to establish any business of their choice and to produce, within limits, any product or service the market requires. This system, in which individuals themselves decide what to produce, how to produce it and at which price to sell their product, is called a **market economy** (or **market system**). This is the prevailing economic system in South Africa.

The market economy is a complex system comprising various types of small and large business organisations that collectively mobilise the resources of a country to satisfy the needs of its inhabitants. These businesses group together to form **industries**. Figure 1.2 shows the composition of the South African business world in terms of major industry sectors and their contribution to the economy.

Figure 1.2: The composition of the South African business world in terms of sector contribution to GDP[2]

Source: Statistics South Africa. 2018. *Gross Domestic Product: Second quarter 2018*. Statistical Release P0441. Available at http://www.statssa.gov.za/publications/P0441/P04412ndQuarter2018.pdf [Accessed 17 October 2018].

The business world or economic structure of South Africa resembles that of many industrialised countries, with a formal and informal sector. In the **formal sector**, large businesses such as Standard Bank, Naspers, Vodacom, Anglo American, Tiger Brands and many other large public corporations – 375 of which are listed on the Johannesburg Securities Exchange (JSE) – are responsible for most of South Africa's economic activity. As market economies develop, they tend to become less dependent on primary economic activities like mining and agriculture and more dependent on services. In 1920, for example, agriculture and mining combined contributed about 37 per cent to the gross national product (GNP), compared to the 32 per cent contributed by the

service sector. As we can see in Figure 1.2, in 2018 the service sector contributed more than 50 per cent of the GDP, with the contribution of agriculture and mining combined shrinking to about 10 per cent.

Large businesses in South Africa contribute to about 70 per cent of the country's economic activity as reflected by turnover, while small, medium and micro enterprises (SMMEs), which are mostly family or individually owned, contribute to about 30 per cent.[3] Many microenterprises form part of the so-called **informal sector**.[4] They are not part of the formal economy because they are not registered and many people involved in these enterprises live primarily on a subsistence or survival basis. Moreover, such businesses often put pressure on the infrastructure of inner-city areas, as due to their informal nature they do not contribute to rates and taxes. It is estimated that these businesses contribute approximately eight per cent of the annual GDP.[5]

The variety of needs that a country has determines the complexity of its business environment. In First World countries, businesses are the primary source of products, services and employment. Figure 1.3 shows the importance of the South African business world in providing employment in South Africa, with the formal sector providing by far the most jobs. However, it is also clear that informal businesses, farms and private households are important providers of employment in a developing market economy. The high unemployment rate in South Africa of about 27 per cent in 2018 and the 2,8 million 'discouraged work seekers' is of great concern, as it suggests that the prevalent institutional arrangements and economic growth rate in the country are not supporting the establishment and growth of businesses.

Figure 1.3: Sources of employment

Source: Statistics South Africa. 2018. *Quarterly Labour Force Survey. Second Quarter 2018*. Statistical Release P0211. Available at http://www.statssa.gov.za/publications/P0211/P02112ndQuarter2018.pdf.

Business creates wealth, is a catalyst for economic growth and is credited with bringing about the high standard of living in developed countries. Take, for example, the role business has played in the United States. In the space of two centuries, the United States went from being a relatively undeveloped nation to a leading industrial nation, which at that time owned nearly 40 per cent of the world's wealth with only 6 per cent of the world's population. Adopting a more market- and business-oriented approach has also been of great economic benefit to emerging economies such as China and India. In China, for example, the gross national income (GNI) per capita[6] grew from about $1 100 in 2002 to $8 690 in 2017 – a growth of almost 700 per cent in 15 years.[7]

Business also serves the community indirectly by means of technological innovation, research and development, and improvements to infrastructure. It plays a crucial role in supporting, in various ways, education, the development of human resources, the arts, conservation, sport and other activities that improve the quality of life of a community.

The business world and society both depend on and influence each other. This is the core of sustainability, the ability of a business to survive and prosper over long periods of time. If a business behaves in a way that allows its stakeholders (such as the communities it operates in and the environment) to benefit too, in exchange for a fair profit, it has a better chance of surviving in the long term. However, practices that strive to ensure excessive short-term profits and that are detrimental to stakeholders will

most often not be sustainable and will be to the detriment of the business. In South Africa, we have seen the growth of **corporate social responsibility**, and the voluntary compliance of businesses with practices that are sustainable. This is discussed in more detail in Chapter 5.

At the heart of the business world is the entrepreneur or businessperson. In the pursuit of profit, entrepreneurs constantly search for new ideas, new products and new technologies. In so doing, they initiate innovation and bring about change by virtue of their decisions on investment, production and employment, influencing not only the state of the economy, but also the prosperity of whole communities.

Consider, for example, local entrepreneur Sarah Collins, inventor of the Wonderbag, a South African-made heat retention cooker. Made from traditional shweshwe Africanprint fabric, the Wonderbag resembles a beanbag filled with repurposed foam, and is used to keep a boiling pot cooking after it has been taken off the stove or fire. This environmentally friendly product is now sold in 52 countries, and already has 1,3 million users. The Wonderbag is manufactured in Tongaat, KwaZulu-Natal, employs local women and is then sold to South Africans and exported to countries like the United States and Australia. There are also satellite manufacturing sites in East Africa, West Africa and in Turkey. Collins said that the Wonderbag has led to 10 000 entrepreneurs starting ventures like selling Wonderbags or catering businesses.[8]

Conversely, society exerts its influence on the business world in a number of ways. If businesses fail to abide by the expectations and desires of the community, regulation and legislation to curb or control such practices can be instituted or enforced. In South Africa we have seen anti-competitive behaviour in several industries, such as the cement industry, the bread industry and the construction industry in the past few years. Getting together with other producers to allocate markets, fix prices and share information has only one purpose: to keep prices as high as possible. This kind of behaviour is to the detriment of smaller producers and to consumers, especially the poor, and is punishable by severe fines by the Competition Commission, a government body instituted to ensure fair competition. The Consumer Protection Act (No. 68 of 2008) also aims, among many other objectives, to prohibit unfair business practices and promote a consistent legislative and enforcement framework to protect consumers.

However, the legal route is not the only route available to society. By means of stakeholder activism businesses can also be influenced to behave more responsibly. The Occupy Wall Street (OWS) movement targeted a number of issues relating to social and economic inequality, greed, corruption and the undue influence of large corporations on government. The slogan of OWS – 'We are the 99 per cent' – reflected the social and economic inequality in the United States and the goals of the organisation ('we are the 99 per cent that will no longer tolerate the greed and corruption of the 1 per cent'). OWS was a leaderless organisation that used the Arab Spring tactic to achieve its goals.[9] The movement started in September 2011 with thousands of protesters camping in Zuccotti Park in New York's Wall Street financial district. The movement gained a largely unrecognised victory in the momentum it built for a higher minimum wage when it motivated fast-food workers in New York City to walk off the job in November 2012, sparking a national workerled movement to raise the minimum wage to $15 an hour. This resulted in several states and cities voting for higher minimum wages in 2014.[10] The e-toll system in Gauteng provides another example of the effect of societal pressure, with pressure groups such as the Organisation for Undoing Tax Abuse (OUTA) being one example of an organisation that has fought on all fronts (legal and otherwise)

to prevent e-tolling in Gauteng. OUTA has expanded its activities to address other perceived tax abuses such as corruption in state-owned enterprises.[11]

The attitude of society towards the business world is by no means consistent, for in a changing environment the community will, at different times, have different expectations of the business world. If the business world fails to respond to the expectations of the community, the attitude of the community towards the business world is likely to change. Consider, for example, the issue of equity in South African organisations. When South Africa became a democracy in 1994, businesses were called on to offer redress to previously disadvantaged individuals (PDIs). These programmes required, *inter alia*, the appointment of PDIs, increasing PDI shareholding in businesses and preferential procurement from black-owned businesses. However, because businesses were slow to respond to this call, government instituted legislation that forces the business world to transform its organisations so that PDIs are included at all levels. The Employment Equity Act (No. 55 of 1998) and the Broad-Based Black Economic Empowerment Act (No. 53 of 2003) are examples of society's response to the exclusion from business of PDIs, women and people with disabilities. (See Chapter 12 for a more in-depth discussion on the South African labour legislation framework.)

Most Western countries have, over the years, come to regard the business sector as a valuable social institution because it has helped to realise society's needs and also to raise the standard of living. In the closing decades of the 20th century, however, most Western nations realised that a high standard of living amid a deteriorating physical environment and inadequate social progress is not sustainable. The business world is thus under continuous and often increasing pressure to behave in ways that are sustainable. There are several themes related to sustainability. In this chapter we discuss five themes, namely social responsibility, employment equity, business ethics, consumerism and environmental sustainability. A discussion of these factors will follow.

The **social responsibility** of business is a concept that originated in media revelations of malpractice by businesses and the resultant insistence of society on restricting such malpractice through regulation. Historically, the social responsibility of a business has been measured by its contribution towards employment opportunities and by its contribution to the economy. But while these factors remain important, many other factors are now included in assessing the social performance of a business. Businesses are nowadays under more pressure than ever to behave as responsible citizens (leading to the notion of corporate citizenship). Their role accordingly goes beyond financial success to include, *inter alia*, the provision of a responsible and safe workplace, the provision of housing, concern about health issues, involvement with community issues, environmental awareness and the empowerment of previously disadvantaged individuals, both economically and managerially. Social responsibility is discussed in more detail in Chapter 5. Businesses often contribute voluntarily and directly to social causes and community upliftment by way of **corporate social investment**.

Employment equity is the notion that the composition of the workforce at all levels should reflect the composition of the community. It aims to create equal employment opportunities for all and redress the inequalities of the past by ensuring that workforces are composed in roughly the same proportions as the groups that make up the population as a whole. In South Africa, the Employment Equity Act became law in 1998. The stated intention of the Act is to eliminate unfair discrimination, ensure employment equity and achieve a diverse workplace that is broadly representative of the country's demographic realities. The inclusion of previously disadvantaged individuals and other

designated groups (such as the physically disabled) at management level is of crucial importance to South Africa's economy to ensure that the government's economic growth targets can be achieved.

The South African government's Accelerated and Shared Growth Initiative for South Africa (AsgiSA) strategy aimed for an economic growth target of 4,5 per cent per year for 2005 to 2009, and 6 per cent per year thereafter. However, while South Africa's GDP grew by approximately 5,1 per cent in 2007, it only grew by 3,1 per cent in 2008, and then followed the rest of the world into recession. By June 2009, South Africa's GDP had decreased by an annualised rate of 6,4 per cent and, while growth has recovered somewhat, it has remained at levels not nearly high enough to achieve our national growth targets; for example, only 1,32 per cent growth was achieved in 2017.[12] For the South African economy to grow at the much-needed level of 6 per cent or higher, there must be enough skilled managers to drive the economy. It is widely recognised that even a moderate real economic growth rate of 2,7 per cent per year will require an additional 100 000 managers each year for the foreseeable future.

Since the traditional source of managers (the population of white males) has been decreasing in relative terms, most of the managers that are required will have to come from the black population. Since 1994, there has been a steady increase in the number of black managers. Despite this growth, the white population – especially the white male population – remains over-represented in management structures. However, these levels are changing slowly but surely. According to the Commission for Employment Equity, in South Africa in 2017, 22 per cent of senior managers were black (up from 9 per cent in 2001) and 56 per cent were white (down from 81 per cent in 2001). In 2017, females of all races accounted for only 39 per cent of senior managers (up from 20 per cent in 2001). Of professionally qualified employees in 2017, 42 per cent were black (up from 33 per cent in 2001) and 37 per cent were white (down from 56 per cent in 2001). Females represented 47 per cent of this category, up from 38 per cent in 2003.[13]

CASE STUDY: The growth of broad-based BEE in South Africa

It is generally accepted that ownership is by far the most successful area of transformation, with billions being spent to transfer ownership to previously disadvantaged individuals. According to research by Intellidex, by 2014 BEE ownership deals done since 2000 had created R317 billion in total value attributable to beneficiaries. By 2017, R52 billion had gone to charities, with R32,6 billion of this ending up as endowments in 27 foundations created through such deals.

A further indicator of the impact of broad-based BEE in South Africa, as highlighted by Empowerdex, is the number of black directors on the boards of JSE-listed companies. In 1992, South Africa had 15 black directors on the boards of JSE-listed companies. In 1997, there were 98. By 2003, this number had increased to 207 and in 2016, there were 1 043 black directors. However, The South African Institute of Chartered Accountants (SAICA) noted in a 2014 study that 8 per cent of all JSE-listed directorships were held by black women, 5 per cent by white women, 17 per cent by black men and 70 per cent by white men. In addition, growth in BEE appointments in directorships seems to be slowing, suggesting that a renewed focus on BEE may be required. In 2017, the top five performers on the JSE with regard to BEE were as follows:

Sources: Intellidex. 2017. The Empowerment Report: Special Edition. Available at http://www.intellidex.co.za/wp-content/uploads/2018/03/MEC-2017-printed-version-editorial-only.pdf. [Accessed 22 October 2018]; Ziady, H. 2017. BEE deals — the surprising truth. *Financial Mail*. Available

at https://www.businesslive.co.za/fm/fm-fox/2017-06-29-bee-deals-the-surprising-truth/. [Accessed 22 October 2018]; Dobbin, J. 2016. JSE-listed directors still mainly pale males — majorities grossly under-represented. *Mail & Guardian*. Available at https://mg.co.za/article/2016-08-31-00-jse-listed-directors-still-mainly-pale-males-majorities-grossly-under-represented [Accessed 22 October 2018].

Business ethics is a concept that is closely related to social responsibility, but where social responsibility focuses on the organisation, business ethics focuses specifically on the ethical behaviour of managers and executives in the business world. Managers, in particular, are expected to maintain high ethical standards, as they are often in positions where they can abuse their power, for example to award contracts. To make business ethics practical, many organisations nowadays have codes of business conduct to provide clear guidelines to managers on what is ethical and what is not. One common rule, for example, is that no business gifts may be accepted, or that all gifts over a certain value have to be declared. Chapter 5 will focus on social responsibility and business ethics.

While there are business concepts regulating the business environment, its employees and society as a whole, specific reference should be made to the concept of consumerism. **Consumerism** is a social force that protects consumers against unsafe products and malpractice by exerting moral and economic pressure on businesses. In South Africa, the South African National Consumer Union acts as a watchdog for consumers and many avenues for consumer protection have already been instituted, while more legislation has also been instituted to protect consumers. Some observers have suggested that the Consumer Protection Act (No. 68 of 2008), signed into law in 2011, makes South African consumers among the best-protected consumers in the world. It forces the producers of goods and services to take full responsibility for ensuring that their products and services comply with standards, and the Act enforces certain minimum warranties and indemnities to protect the buyers of goods and services.

Society has also become more concerned about **environmental sustainability** and increasingly stakeholder activism and legislation are forcing businesses to take the environment into consideration. Businesses are unfortunately frequently responsible for air, water and soil pollution, and for the resultant detrimental effects on fauna and flora. Citizens therefore often form pressure groups to protect the environment. Greenpeace is perhaps the best-known environmental pressure group globally. In November 2017 a group of 15 Greenpeace activists with nuclear barrels blocked the main entrance of the South African Department of Environmental Affairs. The protest was directed at getting the Department to withdraw the environmental authorisation for a proposed new nuclear power station at Duynefontein.[14]

The business world is so interconnected with society that it may be defined as a process that uses a country's means of production to produce products and services to satisfy the needs of people. The primary purpose of business in a free-market system is, therefore, to make a profit while satisfying the needs of the people. A brief overview of the needs of communities, and of the means of satisfying these needs, is given below to explain not only the purpose of business in a market system, but also the extent of the field of **business management**, which is the focus of this book.

1.3 Needs and need satisfaction

1.3.1 The multiplicity of human needs

The continued existence of humans depends upon the constant satisfaction of numerous needs, both physical and psychological. The work that every member of a community performs is directly or indirectly related to need satisfaction. Even in the most remote and uninhabited areas, certain products and services are needed.

Needs may be very simple and few, as in the case of a rural and underdeveloped community in which individuals or families, with the help of nature, find the resources necessary to satisfy a simple need structure. For example, the traditional lifestyle of the San people of the Kalahari depends on the satisfaction of the most basic necessities for survival. However, in highly industrialised communities, needs may be numerous and may therefore require large and complex organisations to satisfy their needs. A need may have a physical, psychological or social origin, but no matter which form it takes, it requires satisfaction. The number of identifiable needs is infinite. Some needs, particularly those that are physiological, are related to absolutely basic necessities, such as the satisfaction of hunger and thirst. These needs have to be satisfied for the sake of survival. Other needs, particularly those that are psychological, relate to things that make life more pleasant, but that are not essential to survival. These needs include the need for holidays, cellphones, dishwashers, swimming pools, luxury cars, and innumerable products and services of a similar nature.

Basic physical and psychological needs may also overlap. For example, people do not wear clothes merely for warmth and protection, but also to be fashionable. Some people enjoy expensive delicacies accompanied by fine wines in luxurious restaurants and, in this way simultaneously satisfy survival needs and psychological needs.

Abraham Maslow (1908–1970) was an American clinical psychologist who explained variable and unlimited human needs by means of a hierarchy of needs. According to Maslow, human needs range, in a definite order, from the most essential for survival to the least necessary. The left-hand side of Figure 1.4 shows **Maslow's hierarchy of needs** (see section 12.7.2.2 in Chapter 12 as well). It is clear from Figure 1.4 that the needs hierarchy is composed in such a way that the order of importance ranges from basic physiological needs, which have to be satisfied for survival, to psychological needs, with which the higher levels of the hierarchy are mainly concerned. Because humans are social beings who live in communities, they also have collective needs, such as protection and education. An individual, a family or a community first satisfies the most urgent needs, and then, when this has been done, moves up to the next level until the higher psychological levels are reached. With changing circumstances, individuals not only desire more possessions, but also continually want still newer and better products and services. For example, radio offers entertainment, but black-and-white television is believed to offer better entertainment, and colour television still better entertainment. Once these products and services have been acquired, however, the need arises for a DVD player, more television channels and content – as evidenced in the phenomenal growth of DStv and Netflix – and more and better programmes. As society satisfies one need, a new one comes into existence, and there is no end to the constantly increasing number of human needs.

Table 1.1 below indicates some of the needs people (households) have and what they spend their income on. It is interesting to note that in 2014/2015, South African households spent, on average, about 13 per cent of their income on food, which satisfies one of the most basic needs. However, in higher-income households relatively less is spent on food, and more is spent on entertainment and other discretionary activities, while lower-income households spend comparatively more on food as a percentage of their income. It is important to keep in mind that the percentages given in Table 1.1 are

of average household consumption. Since South Africa has a diverse population, it also has diverse needs and consumption patterns. From Table 1.1 we can also see how needs change over time for various reasons. For example, expenditure on housing, water, electricity, gas and other fuels has increased sharply, due, *inter alia*, to dramatic increases in electricity tariffs, higher estimation of house values leading to higher property taxes, and higher rental prices. Increased spending in one area leads to decreased spending in other areas, and we can see how relative spending on food, clothing and household maintenance have decreased.

Table 1.1: Expenditure patterns for South African households

Products and services bought	Expenditure in 2005/6 as % of total expenditure	Expenditure in 201 total expenditure
Food and non-alcoholic beverages	14,4	12,9
Alcoholic beverages and tobacco	1,02	0,9
Clothing and footwear	5,0	4,8
Housing, water, electricity, gas and other fuels	23,6	32,6
Furnishings, household equipment and routine maintenance of the house	6,9	5,2
Health	1,7	0,9
Transport	19,9	16,3
Communication	3,5	3,4
Recreation and culture	4,6	3,8
Education	2,4	2,5
Restaurants and hotels	2,2	2,1
Miscellaneous products and services	14,4	14,7
Other unclassified expenses	0,3	0,1
Total	**100**	**100**

Source: Statistics South Africa. 2017. *Living conditions 2014/15*. Statistical Release P0310. Available at http://www.statssa.gov.za/publications/P0310/P03102014.pdf. [Accessed 22 October 2018].

1.3.2 Society's limited resources

If one considers the multiple and unlimited needs of humans, especially in highly developed societies, it is clear that there are only limited resources available to satisfy all their needs. Although Western countries, most notably the United States, possess

very impressive means of production, even they do not have unlimited resources. Water is a key resource to individuals and businesses alike, yet water scarcity is a potentially massive problem facing both South Africa and the world, as we can see in the case study below: 'Keeping Cape Town's taps running'.

A country has only a certain number of people in its workforce to operate a certain number of machines, and a certain number of factories, hospitals and offices to produce a certain quantity of products and services. In other words, the resources of any community are scarce, and can easily be exceeded by its needs. Resources are therefore the basic inputs in the production of products and services, and they are also known as production factors.

Figure 1.4 shows the resources that society possesses in limited quantities only and which it uses to satisfy its needs: natural resources, human resources, capital and entrepreneurship. These resources are discussed in more detail below.

Figure 1.4: The needs and resources of the community

Source: Compiled from information in the chapter.

1.3.2.1Natural resources

Natural resources, also known as the production factor of land, include agricultural land, industrial sites, residential stands, minerals and metals, forests, water and all such resources that nature puts at the disposal of human kind. The most important characteristic of natural resources is that their supply cannot be increased. In other words, the amount of natural resources any one country possesses is given, and is in most cases, therefore, scarce. Moreover, human effort is usually necessary to process these resources into need-satisfying products – for example, in the transformation of forests into timber and paper or, in the case of the airline industry, the refining of oil to produce the jet fuels that aeroplanes need to fly. In the process, natural resources are depleted and may become even scarcer.

1.3.2.2Human resources

Human resources, also known as the production factor of labour, include the physical and mental talents and skills of people employed to create products and services. People receive wages for their labour. The size of the labour force of any country and, therefore, in a sense, the availability of that production factor, is determined by, among other things, the size of the population, the level of its education and training, the proportion of women in the labour force and the retirement age. For the manufacturing processes of a country to be of any value, the country's labour force has to be trained for certain periods and to certain levels of skill to be able to produce the products and services required. Training periods will differ depending on the skill being learnt. For example, the training period of a flight attendant will be considerably shorter than the training period of a pilot. The combination of human skills is of particular importance, for without this combination, natural and financial resources cannot be utilised productively. In South Africa we have a situation where there is an oversupply of unskilled labour and a shortage of certain types of highly skilled labour.

CASE STUDY: Keeping Cape Town's taps running

In the summer of 2017, Cape Town faced a severe water crisis with dams drying up and predictions at one point suggesting that the metro was only days away from running out of water. The drought forced the city and its residents to seriously consider their water usage habits, and to start investigating other options for a sustainable water supply, such as the desalination of seawater. However, alternatives like desalination are expensive. For example, at the Adaptation Futures 2018 conference, Gisela Kaiser, the City of Cape Town's Executive Director for Water and Waste, said that a small temporary desalination plant will take three months and cost R350 million to raise the level of Cape Town's supply dams by just one per cent. The city is also trying to build resilience in Cape Town's water supply, for example by reclaiming storm water - rainfall that usually runs into drains and out to sea.

The availability of surface water in the Western Cape water supply system has been reduced by climate change (resulting in less rain) and the invasion by alien vegetation in water catchment areas. Cape Town is by no means alone in this crisis. Australian city Perth's annual rainfall has been declining by 3mm a year on average, while average temperatures in the region have increased by 1°C in the last 40 years. Perth subsequently relies less on dams and more on desalination and groundwater for their water supply.

Whilst the urban water problem might appear to be a Cape Town-specific problem, Hastings Chikoko, Regional Director for C40 Cities in Africa, has commented that one in four large cities globally are water stressed.

Sources: Compiled from information in Gosling, M. 22 June 2018. Getting below the surface of the Cape Town water crisis. *News 24*. Available at https://www.news24.com/SouthAfrica/News/getting-below-the-surface-of-the-cape-town-water-crisis-20180622 [Accessed 22 October 2018]; Adaption Futures. 2018. 5th International Climate Change Adaptation Conference. Cape Town 18 - 21 June. Available at https://adaptationfutures2018.capetown/ ; Water outlook 2018 report. 2018. Department of Water and Sanitation. City of Cape Town. Available at http://resource.capetown.gov.za/documentcentre/Documents/City%20research%20reports%20and%20review/Water%20Outlook%202018_Rev%2030_31%20December%202018.pdf.

1.3.2.3 Capital

Capital is represented by the buildings, machinery, cash registers, computers and other products, produced not for final human consumption, but for making possible the further production of final consumer products. Capital products usually have a long working life – for example, office buildings, factories, machinery and other equipment may be used over and over again in the production process. In the airline industry, capital usually has an exceptionally long working life, but also comes at a very high price. The reason for the scarcity factor of capital is that a community takes years to build up its stock of capital. Every year it spends a certain amount on things such as roads, bridges, mine shafts, factories and shopping centres, and there is always a shortage of these things. The owners or suppliers of capital are usually remunerated in the form of interest or rent.

1.3.2.4 Entrepreneurship

Entrepreneurship is the fourth factor of production. It refers to the collective capacity of entrepreneurs, who are those individuals who accept the risks involved in providing products and services for their society. Entrepreneurs like Simbarashe Mhuriro (see box Entrepreneurship in solar power) take the risk of providing their knowledge and capital in setting up a business with the prospect of being rewarded with significant profits if they are successful. On the other hand, if they do not succeed, they may lose a lot. The production factor of entrepreneurship is scarce in the sense that not everybody in a community is prepared to take the risks that are inevitable when providing new products or services, or has the ability to manage an organisation successfully. Although the contemporary focus on entrepreneurship is mainly on small and medium

businesses, entrepreneurs are not limited to these. A large or corporate business is also a place for entrepreneurship. (See Chapter 2 for a more detailed discussion on entrepreneurs and entrepreneurship.)

Entrepreneurship in solar power

Simbarashe Mhuriro is the founder and Managing Director of Oxygen Energy Private Limited, an independent power producer and renewable energy development company that specialises in utility scale power plants and industrial and commercial rooftop projects. In 2017, the African Development Bank (AfDB)-managed sustainable energy fund for Africa (SEFA) approved a US$ 965,000 grant to Oxygen Energy Private Limited. The grant will enable the preparation of a bankable business case for the development of a 20MW off-grid solar photovoltaic rooftop project on buildings owned and managed by Old Mutual Property Group, the largest property investment managers in Zimbabwe. When the project is completed, it will provide reliable and competitive solar power to hundreds of small- and medium-sized enterprises throughout Zimbabwe.[15]

1.3.3 Need satisfaction: A cycle

To be able to satisfy the needs of the community, entrepreneurs have to utilise scarce resources in certain combinations to produce products and services. Economic value is created in the course of the production process by combining production factors in such a way that final products are produced for consumers. A nation's survival depends on the satisfaction of its people's needs. Striving for need satisfaction with the limited resources available is an incentive for economic progress.

Given its unlimited needs but limited resources, society is confronted with the fundamental **economic problem**: how to ensure the highest possible satisfaction of needs with these scarce resources. This is also known as the **economic principle**. Society cannot always get what it wants, so it must choose how it will use its scarce resources to the maximum effect to satisfy its needs. In short, it has to decide about solving the following economic issues:

- Which products and services should be produced, and in what quantities? (How many capital products should be produced? How many consumer products should be produced? Should railways or trucks, houses or flats be built? If flats are chosen, how many should be built?)
- Who should produce these products? (Should the state or private individuals take charge of production? Or should this responsibility be shared, as in the case of South Africa's airline industry?)
- How should these products and services be produced, and which resources should be used? (There are various methods of production and types of resources that should be considered. For example, should a production-line method be chosen? Should a labour-intensive approach be used?)
- For whom are these products and services to be produced? (Will the products cater largely for the needs of the rich or the poor? Will services be aimed at business clients or families?)

The answers to address the economic issues listed above are given by the community. The **community** decides which **institutions** should be responsible for the production and distribution of products and services, as well as the role that each institution has to play. In South Africa we are constantly seeing debates around nationalisation and privatisation, with some arguing that strategic sectors (such as mines and banks) should be controlled by government (nationalised), while others argue that key state assets such as Eskom can only reach its full potential if it is not controlled by the state but by

private investors (privatisation). This is an example of a community seeking an answer to the question of who should produce these products or services – the state, private enterprise, or a combination of the two.

Figure 1.5 shows how, against the background of its needs, and by means of its political process, the community determines the **economic system** in which the necessary need-satisfying institutions are established.

In a market economy, need-satisfying institutions, including business organisations and government organisations, offer products and services on the market in return for profit. If the community is not satisfied with the way in which these organisations provide for its needs, it will change the economic system or choose a new need-satisfying system. The appearance of new businesses and the disappearance of others are examples of this cycle of need satisfaction in the community.

Another example of this cycle at work that illustrates the community getting what it wants occurred in the form of South African businesses offering longer shopping hours from 1965 onwards. This change occurred because of the large-scale urbanisation of South African society and the participation of women in the labour markets. These women found the opportunity to shop on Saturday afternoons and Sundays very useful.

Figure 1.5: The cycle of need satisfaction in a community

Source: Compiled from chapter content.

Over the years, different communities have developed different approaches in order to satisfy their needs, and different economic systems have been tried and tested. Each of these systems, as chosen by various communities to satisfy specific needs, has its own approach to the fundamental economic problem of which products and services should be provided by whom and for whom. The study of these systems constitutes the field of economics as a social science and examines the means used to satisfy innumerable human needs with limited resources. Business management, in contrast, is concerned with the institutions that are created in the economic system to satisfy the needs of a community, and these are mainly business organisations.

To provide some necessary background to the study of business management and the role of business organisations in society, a brief overview of the different economic systems now follows.

The changing need for communication

The needs of society ultimately culminate in products or services that satisfy particular needs. A case in point is cellphones. People have a basic need to communicate and, where this is possible, to communicate with individuals over long distances. During most of the last century, the only way this could be done was by means of the telephone, where the caller first had to call a specific building (house or office) and then wait for the relevant person to answer, or to be found by whoever answered the phone. The cellphone was, therefore, a response to the need to communicate immediately with a specific individual, without the inconvenience of having to locate the person first or the frustration of dealing with inoperative telephone lines.

As consumer needs have evolved, so did the design and functionality of cellphones and other mobile devices. Cellphones are no longer just a means of communication. The emergence of new mobile technologies in the form of smart phones (like the Samsung S-series and the iPhone) and tablets (such as the iPad and Samsung Galaxy Tab) have taken

mobile communication to a new level. Nowadays, cellphones also serve as high-megapixel cameras, radios, music players, memory cards, email and Internet access devices, geographical positioning systems (GPS), and online banking devices.

It is interesting to note that in 2018, the number of cellphones in South Africa exceeded the population. At the same time, the number of cellphones seems to be declining, while the use of smart devices like the iPhone is on the rise as consumer needs change and they exchange their mobile phones for smart phones or tablets. Internet access is on the rise, with about 56 per cent of South Africans using the Internet in some form. The importance of, and increase in data usage is reflected by the fact that more than 75 per cent of Internet traffic is generated by mobile devices. [16]

1.4 The main economic systems

1.4.1 The community and its economic system

Every community is engaged in a struggle for survival that is necessitated by scarcity. Therefore, each community needs to have a complex mechanism that is constantly dealing with the complicated task of ensuring that the production and distribution of products occurs. Each country is confronted with the fundamental economic problem of which economic system to choose to solve the problem of which products should be produced and marketed by which producers for which consumers. Each country must decide on some system to solve that problem.

Over the years, countries and communities have approached need satisfaction in different ways. There are three main approaches that are still followed by present-day communities for the solution of their fundamental economic problems. They are the market economy, the command economy and socialism. While these economic systems are often incorrectly referred to as political ideologies, they should rather be described as economic systems influenced by politics. It is necessary to take a brief look at these systems to understand the origin and role of business organisations in society. As none of these economic systems is ever found in a pure form, the discussion that follows is merely an exposition of the basic premises of each system.

1.4.2 The market economy

One of the economic systems adopted for solving economic problems is the market economy, also known as the free-market economy or free-enterprise system.

It is a system in which most products and services demanded by a community are supplied by private organisations seeking profits. It functions on the following assumptions:

- Members of a community may possess assets and earn profits on these.
- The allocation of resources is affected by free markets.
- Members of the community can freely choose between products, services, places of residence and careers.
- The state keeps its interference in the system to a minimum.

In the market economy, particular value is attached to the right of individuals to possess property such as land, buildings, equipment or vehicles, including the right to earn an income from this property. This right is also the driving force of the market economy: it stimulates individuals and entrepreneurs to acquire more assets and to make a profit through the productive utilisation of their assets or their capital. In the pursuit of maximum profits, this capital, which is nothing other than the resources of the community, is applied as productively as possible.

This aspect also affects the distribution of resources through free markets. The private possession of capital has an important influence on the manner in which resources are allocated or employed in a market economy, as the decisions about what products should be produced by which producers rest with those who own the resources.

This means that farmers, factory owners, industrialists and individuals are free to do what they like with their assets. However, in their decisions concerning production and marketing, they have to take account of the tastes, preferences and other demands of consumers if they want to make a profit. Thus, the question of which consumers' needs should be met (for whom?) is answered. Such decisions in a market economy are not taken by some central body but by a system of free markets, which indirectly puts a price on every production factor or consumer product.

Free markets also imply the third characteristic of this system: freedom of choice. The producers are able to decide whether they can profitably produce their products at the prices set by the market. This is the producers' free choice. Likewise, the consumer is free to choose whether to buy the product at that price. The consumer is also free to live where he or she wishes and to study and train for whichever career he or she wants to follow. A system of free markets therefore necessarily entails freedom of choice. Private owners of property are free to own what they like and to do with it as they please: rent it out, sell it, exchange it or even give it away. People with businesses are free to produce what they wish and to employ whomever they choose. Similarly, workers, who own their labour, can use this human resource as they choose. In this way, **competition** comes into operation in a system of free markets.

The final characteristic of a free-market economy is minimum state interference in markets. The assumption is that the state should merely ensure the proper maintenance of the system without excessive regulation of, or even participation in, the business world.

However, market economies are not all about good news. With the global financial crisis in 2008, free market economic systems (capitalism) came in for a lot of criticism, as the perception developed (with good reason) that bankers took huge and unsustainable risks based on little but greed, and when the system collapsed the state and ordinary people had to bear the cost. Capitalism has also been criticised for creating inequalities in society between rich and poor, the very aspect that movements like Occupy Wall Street opposed so strongly. More recently in South Africa, Adv Terry Motau SC and Werksmans Attorneys produced a damning report into fraud, probable money laundering and reckless business practices at VBS Mutual Bank, finding that more than 50 people unjustifiably and illegally received almost R2-billion between 2015 and 2018, leading to the collapse of the institution.[17] The VBS Mutual Bank scandal has once again illustrated how corruption and greed led to massive losses for local governments (many of them serving poor communities) and lower income individuals who had their savings deposited at the institution.

1.4.3 The command economy

The second type of economic system is a **command economy** or a centrally directed economic system. Adopted by some countries as an alternative to a market economy, it was until recently known as communism. Its main characteristic is that the state owns and controls the community's resources or factors of production.

A command economy is a system of communal ownership of a country's factors of production in which the individual owns no property, with the exception of private

domestic assets. This means that individuals own no land, factories or equipment. The state assumes complete responsibility for the production and distribution of products and services, and all decisions about what should be produced – and about how, by whom and for whom it should be produced – rest with a central government.

The choices of products and services are therefore limited to what the state offers; the design of these products falls entirely outside the control of ordinary individuals. It is the state that decides what the needs of the community are, how and where the desired products will be obtainable, and in which quantities they may be used. In the absence of free consumer choice, the profit motive is also absent, as is the competition factor, because, as mentioned above, the state owns the organisations that produce the products and services.

In most countries that adopted a command economy, the system failed because it robbed individuals of the initiative to produce products and services, and it prevented the creation of wealth. The poverty of the Soviet Union and other Eastern European countries and their collapse in the late 20th century is evidence that the system did not create wealth. Command economies are, nevertheless, still officially adhered to in Cuba, North Korea and some African states.

1.4.4 Socialism

Socialism is the third economic system, and may be regarded as a compromise between a pure market economy and a pure command economy. Under socialism, the state owns and controls the principal (generally strategic) industries and resources, such as manufacturers of steel, transportation, communications, health services and energy. Less important and smaller matters such as trade and construction, as well as the production of materials and services of lesser strategic importance, are left to private initiative. In socialism, the fundamental assumption is that strategic and basic resources should belong to every member of the community. For the rest, businesses and consumers operate within free markets in which they are at liberty to make decisions without restriction. Although consumers in a socialist economy have greater freedom of choice than those under a command economy, the provision of the basic products and services by the state is a limiting factor in the creation of wealth.

A free economy creates wealth

The Heritage Foundation and *Wall Street Journal's* 2018 Index of Economic Freedom[18] measures how well 180 countries score on an analysis of 10 specific components of economic freedom. These components include business freedom, trade freedom, fiscal freedom, government size, monetary freedom, investment freedom, financial freedom, property rights, freedom from corruption and labour freedom. Taken cumulatively, these factors offer an empirical snapshot of a country's level of economic freedom.

Scores are given out of 100, where 100 and 0 represent the maximum and minimum freedom of an economy respectively. The results demonstrate beyond doubt that countries with the highest levels of economic freedom also have the highest living standards.

Out of all the regions, sub-Saharan Africa scored the lowest on the 2018 Index of Economic Freedom, with an average of 54,4. Mauritius was the highest-ranking African country, scoring 75,1 (down from 76,4 in 2015), making it the 21st freest economy in the world (down from 10th in 2015). The leader in sub-Saharan Africa, Botswana (with 69,9) was second in the region and was rated 35th in the world. South Africa was ranked fourth in the region with a score of 63 and ranked 77th in the world – down from 61st in 2009. Given that South Africa slipped 5 places despite its rating remaining about the same as in 2015, it would seem as if there is a trend for economies to become freer in general. A comparison of 20 selected country economic freedom ratings is presented in Figure 1.6.

The Heritage Foundation remarked that South Africa's economic growth has decelerated because of declining global competitiveness, growing political instability and weakened rule of law. This caused the country's investment-grade credit rating to be downgraded to junk status in 2017, denting investor confidence. South Africa is also plagued by rising public debt, inefficient state-owned enterprises and spending pressures, while the judicial system is increasingly vulnerable to political interference. The numerous scandals (such as the investigation into state capture) and frequent political infighting have severely undermined the integrity of government. Countries with high scores on the Index of Economic Freedom generally earn higher incomes per capita. For example, Hong Kong, which is listed as the freest economy in the world, had an average GDP per capita in 2018 of US$58 322. Countries with lower scores generally produce and earn much less. South Africans, for example, had a GDP per capita of only US$13 225 per capita in 2018.

Figure 1.6: 2018 assessment of economic freedom of different countries

Source: Heritage Foundation. 2018 Index of Economic Freedom. Available at http://www.heritage.org/index/ranking [Accessed 22 October 2018]. Reprinted by permission of the Heritage Foundation.

1.4.5 Mixed economies

None of the three main economic systems in use occurs in a pure form anywhere. They typically occur as **mixed economies**, with the dominant system incorporating certain characteristics of the other systems. Thus China, which officially has a command economy, employs private initiative, while growing state intervention in key industries in the major market economies of the world (especially after the global financial crisis) is no strange phenomenon. The USA is often regarded as a beacon of a free market economy, while it is in fact a mixed economy.

Figure 1.7 shows the relative success of various countries with different economic systems. Citizens in high-income countries earned about $47 510 per capita in 2018, and are usually free market economies (such as Hong Kong and the USA) or developed socialist or mixed economies such as the USA, Sweden and the UK. In comparison, the poorest countries had a GNI of only about $2 085 per capita, and consist mostly of economies that are not free (such as North Korea) or are only just emerging from command economies (such as Ethiopia and Mozambique). The findings depicted in Figure 1.7 seem to support the notion that wealth is generally best created by a well-functioning market economy, while predominantly command economies have not succeeded in creating significant wealth.

Countries such as South Africa, China and Brazil, with unique economic systems, rate about midway between the richest and poorest countries of the world. Several factors, including education, culture and work ethic, affect the prosperity of any particular country, but Figure 1.7 shows that countries with well-functioning market economies are generally wealthier than others.

Figure 1.7: A comparison of the gross national income per capita in 2017 of people in a variety of economic systems

Sources: Adapted from information obtained from the World Bank Doing Business data. Available at http://www.doingbusiness.org/en/data; www.doingbusiness.org and the World Bank data on GNI. Available at https://data.worldbank.org/indicator/NY.GNP.PCAP.PP.CD?locations=CU. [Accessed 24 October 2018].

1.4.6 The state and economic systems

The fact that under both the market system and socialism the state intervenes to help solve the economic problem does not mean that there is necessarily a tendency to move in the direction of a command or centrally directed economy. There are two conflicting views of the role of the state in economic systems. A **conservative** perspective argues that the role of the state should be extremely limited. This view questions the government's ability to solve social and economic problems and argues that the state's role should be carefully limited to what is absolutely necessary. However, there are certain key shortcomings inherent in the conservative view and the free markets it advocates:[19]

- Free markets are subject to economic fluctuations, unemployment and inflation.
- This view creates economic inequality as income is distributed unequally.
- Markets are not always subject to perfect competition and where monopolies or imperfect competition is present, resources may be allocated inefficiently.
- Markets deal poorly with the side effects of economic activity, such as pollution.
- There are certain public goods that the market cannot provide, such as national defence and the justice system.

The **liberal** view points out these important limitations of the market system, and claims that governments can do a great deal to overcome these limitations, such as regulating private economic activity and providing goods and services of which the private sector produces too little. Examples of possible necessary government interventions may include the protection of natural resources by preventing pollution, the restriction of monopolistic practices by ensuring competition, and the protection of consumers against false or misleading information and exploitation. The state can also assist businesses by stimulating the economic system (for example, through promoting exports, encouraging the creation of small businesses, assisting research and granting subsidies). Essentially, government intervention in the economic system should aim to encourage economic growth and stability and effect greater equity in the distribution of income.

A much-debated form of government intervention takes place when the state does not limit itself to the above-mentioned activities, but acts as an entrepreneur and business owner in its own right and even competes with other privately owned businesses. The state does this in the areas of transport services, electricity supply, arms manufacture, broadcasting and television services, and many other industries in South Africa.

The main reasons usually advanced for government intervention is that the private entrepreneur is not interested in these activities and may not even be capable of carrying them out. This may be because of the enormous scale of the businesses that produce services such as transport and electricity, and the corresponding risks attached to them. It is also argued that some organisations are of such strategic importance to the community that they cannot be left to profit-seeking private entrepreneurs.

However, these arguments do not entirely justify a regular and continuous entrepreneurial role played by government. If any such intervention by the state is carried to excess, the result is a bureaucracy that affects national productivity adversely

by limiting private competition. For that reason, among others, public–private partnerships (PPPs) have become commonplace. Governments often use PPPs to develop large capital projects in partnership with private enterprise. They pool their resources to develop, for example, infrastructure, which the private enterprise then runs for profit. Toll roads are a typical example of a PPP, as is the Gautrain, the state-of-the-art rapid-rail project of the Gauteng Provincial Government.

1.4.7 Final comments on different economic systems

Different countries use different economic systems to meet their needs using their available resources. Each system thus has its own peculiar characteristics (as Table 1.2 shows) and each democratic country arranges its economic system in such a way that it solves its wealth problem as effectively as possible in accordance with the wishes of its inhabitants. Bearing in mind that pure forms of the different economic systems almost never exist, the most appropriate description of the prevailing economic system in South Africa is that it is a mixture between the market system and the socialist system. More precisely, the South African economic system can be defined as one that is moving towards a market-oriented economy, yet presently has a high degree of government participation in, and control of, the economy.

Table 1.2: A comparison of the main economic systems

Mobility: The key to future economic growth

The Gautrain has been in operation since 2010, linking Sandton, the OR Tambo International Airport and the City of Tshwane with a high-speed commuter rail system. The Gautrain project is owned by the Gauteng Department of Transport and is a project of the Gauteng Provincial Government, but was built and is operated by the Bombela Consortium. The Gautrain has proved to be very popular with commuters, with 63 000 using the train every weekday.

This multibillion-rand initiative, designed in line with global practice, is a good example of a successful public–private partnership, and aims to enhance and support economic growth in the Gauteng Province and generate employment. When looking at current Gautrain operations, the system contributed R1,7-billion a year to provincial GDP, while sustaining about 6 000 jobs in Gauteng in 2013. The system also increased government revenue by around R400 million a year, with around R200 million received by lower-income households, again mainly through wages and salaries. For every R1 spent on operating the Gautrain, the provincial economy gained another 96c, and the national economy 24c. The Gautrain has also improved the quality of life of the province's residents, reducing road congestion by cutting car trips per day by 21 300.

Around R10-billion was invested in new developments and upgrades to retail centres in a 10 km radius around Gautrain stations between 2009 and 2014. R1-billion was invested in office space, and residential property saw an increase in property value of R12,9-billion.

Source: Venter, I. 9 July 2015. Gautrain boosts GDP, property development, says KPMG report. *Creamer Media's Engineering News*. Available at http://www.engineeringnews.co.za/article/gautrain-boosts-gdp-property-development-says-kpmg-report-2015-07-09 [Accessed 22 October 2018]. Reprinted by permission of Creamer Media.

The South African economy[20]

The economic systems of Western countries, with which South Africa associates itself, are typically combinations of a market economy and socialism. Despite the defects and

shortcomings of the more-or-less free-market order in South Africa, most inhabitants believe that this economic system satisfies their needs better than any system that might be based on pure socialism or a command economy.

Since 1994, South Africa has steadily moved to an increasingly market-oriented position with decreasing government intervention and control. This move has undoubtedly had a positive effect on the South African economy, as can be seen in the figures below.

In 2004, South Africa's GDP figure stood at R1 404 billion and GDP per capita was R30 129. Consumer price inflation was at its lowest level in 40 years (3,4 per cent) and producer price inflation was at a 58-year low (1,9 per cent). South Africa had become an important role-player in global exports and, hence, in the global economy.

By 2007, economic stability was evident in South Africa. With GDP growth of 5,1 per cent for the year, the country's economy was at its strongest in over two decades.

However, South Africa was not able to avoid the effects of the global meltdown in 2008, when the country's GDP grew by only 3,1 per cent. By June 2009, GDP had decreased by 6,4 per cent to -1,7 per cent, pulling South Africa's economy into recession. Growth recovered somewhat in 2010 through 2014, although it did not reach the growth targets set by the government, and in 2017 and 2018 growth slowed considerably. The annual compound 5-year growth rate for South Africa is 1,3 per cent, compared to 3,4 per cent for Nigeria. By 2017, South Africa was the second largest African economy with a GDP of US$739,4 billion (second only to Nigeria with a GDP of US$1,1 trillion) and a GNI per capita of US$13 090 (compared to US$5 680 for Nigeria).

Certain factors make South Africa a favourable investment destination and other factors deter investors from the country.

Positive factors include:

- Sound macroeconomic policies;
- 100 per cent ownership permitted;
- A large, growing domestic market in South Africa;
- Modern transport and communication systems;
- Rich in natural resources; and
- Modern banking and financial services.

Negative factors include:

- High rates of crime and corruption;
- Weak economic growth;
- Extensive exchange controls, although these are gradually being eased;
- Major skills shortages, particularly in management roles; and
- High levels of unemployment (currently at over 27 per cent).

South African consumers enjoy a high degree of freedom to buy what they want and to shop where they want.

In South Africa, individual entrepreneurs must judge which products and services consumers want, and then offer these at a price the consumer is prepared and able to pay. A complex network of organisations evolves out of the interaction between needs and the entrepreneurs who satisfy these needs. In a market economy, this network is termed the business world.

1.5 The need-satisfying institutions of the market economy

1.5.1 Business organisations

The workings of a market economy are affected by its **need-satisfying institutions**, which are the private business organisations that, for the most part, satisfy the needs of the community. The business world therefore consists of a complex system of interdependent organisations that mobilise the resources of a country to satisfy the country's needs at the risk of a loss and in the pursuit of profit.

Such are the conditions under which a private business exists in a market economy. Under such a system, an organisation has to make a profit to be able to survive. This can happen only if it satisfies the needs or wishes of the consumer and, hence, the community.

By meeting the needs of the consumer, business organisations solve the fundamental economic problem: which products and services should be produced, how they should be produced, and for whom.

Figure 1.8 shows how businesses, as the main need-satisfying institutions under this system, use the resources of society to produce products and services for consumers.

Figure 1.8: Products and services offered in the market system

Source: Adapted from Samuelson, P.A. & Nordhaus et al. 1980. *Economics*. Eleventh edition. New York: McGraw-Hill Company, p. 41.

Consumers' needs culminate in the demand for consumer products and services offered on the market by businesses (in department stores, boutiques, car showrooms, pharmacies and so on). Therefore, consumer demand helps to determine which products and services need to be provided and for whom.

To be able to produce products and services, business organisations need resources, so a demand arises for production factors, which are offered in the factor market by the community. Business organisations pay salaries and wages to the community in exchange for production factors, and consumers in turn pay for their products and services with that money. Competition in both markets determines how the products and services are to be produced so that the entrepreneur can continue to make a profit.

In order to make a profit, the enterprise must therefore take the initiative and accept certain risks in mobilising the resources of the community before items can be produced. The owner of a bicycle factory, for example, has to erect or rent a building, install machinery, buy raw materials and components, and employ people to manufacture bicycles as productively as possible to satisfy the needs of consumers. The transport contractor has to transport products to places where there is a need for them. The retailer has to present a range of products conforming to consumers' needs in as convenient a way as possible. A banker does not produce a physical article, but provides a service in the form of finance placed at the disposal of manufacturers, dealers and numerous other entrepreneurs and consumers. These are but a few examples of the innumerable activities carried out in the business world by business organisations – large and small, local and multinational – that play an indispensable part in South African society.

Business organisations may be defined as those private need-satisfying institutions of a market economy that accept risks in pursuit of profit by offering products and services on the market to the consumer. Business organisations assume

one of a variety of forms: a sole proprietorship, a partnership, a close corporation, a private company or a public company (as will be discussed in Chapter 3).

While a business organisation is a private enterprise (one owned by private entrepreneurs), in a mixed-market economy there are government and non-profit-seeking organisations (such as organisations for charity) that satisfy community needs in addition to profit-seeking businesses, especially those needs that cannot be addressed profitably by business organisations.

1.5.2 Government organisations

In the discussion of the various economic systems, several principles of a market economy were identified. One principle was the condition that government should intervene as little as possible with market mechanisms and that when it does, it should confine itself to the protection and creation of collective non-profit-seeking facilities and services such as those concerned with healthcare, education, justice and defence. The government departments responsible for such state functions may also be regarded as need-satisfying organisations. However, because the profit motive is absent, and the services provided are collective, such government institutions fall under the subject of public administration rather than business management.

The discussion of the various economic systems also mentioned that the pure market economy exists only in theory and that several mixed systems are in fact to be found, including the South African system, which was defined as a market-oriented economy with a high degree of state intervention. The intervention specifically indicates the large number of government organisations in South Africa, which are also known as state-owned enterprises (SOEs), parastatals or public corporations. Unlike the collective systems that produce products and services on a nonprofit-seeking basis, these public corporations offer products and services for profit, and sometimes in competition with other businesses in the market. Sometimes these public corporations may be regarded as business organisations, but with this difference: they are owned and controlled by the state and not by a private entrepreneur. Eskom, Transnet and South African Airways (SAA) are examples of such public corporations, and there are many others.

These public corporations may also be regarded as need-satisfying institutions through which the state creates products and services believed to be of strategic, economic or political importance to the community, especially as regards self-sufficiency in transport, energy, military equipment and armaments. Despite early successes in privatisation (the state sold Sasol in 1979, in 1998 ACSA was privatised and in 2003 Telkom was listed on the JSE and the New York Stock Exchange), this process has seemed to stall more recently due, *inter alia*, to resistance from labour unions concerned about job losses.

The effectiveness and efficiency of government organisations are often not comparable to that of private organisations. For example, the state has had to bail out state-owned enterprises like South African Airways several times in the past decade, while the performance of others, such as Eskom, the South African Broadcasting Corporation and Prasa is unsatisfactory. However, those that seek profits also fall within the scope of business management.

1.5.3 Non-profit-seeking organisations

Non-profit-seeking organisations are the other group of need-satisfying institutions that offer services, and, to a lesser extent, products not provided by private enterprise or government organisations. Amateur sports clubs, cultural associations and welfare

organisations are all examples of non-profit-seeking organisations, as are associations of organised business such as the National African Federated Chamber of Commerce (NAFCOC) and Business Unity South Africa (BUSA). These organisations differ from other need-satisfying organisations in that they provide their services without seeking profit.

The continued existence of such organisations therefore depends on the financial support of those members of the community who require their services or from charitable contributions. Although such organisations do not set profit-making as their primary objective, they often function on the same basis as a business organisation, seeking a surplus of income over expenditure, or at least a balance of income and expenditure. These organisations – especially the larger ones – therefore employ management principles. Despite their small share in the economy, the study of such organisations also falls within the field of business management.

1.6 The nature of business management

1.6.1 Economics and business management as related sciences

A society is constantly faced with the problem of how to use its scarce resources to satisfy its needs as efficiently as possible. Economics is a social science that studies how humans choose different ways of using their scarce resources to produce products and services. It is therefore a study of the economic problem and related variables, with the improved well-being of the community as its preconceived goal. The variables that economics studies include prices, money, income and its distribution, taxes, productivity, government intervention and economic growth, as well as many other economic questions affecting the well-being of a country.

Business management is an applied science that is concerned with the study of those institutions in a particular economic system that satisfy the needs of a community. In a mixed-market economy, as is found in South Africa, private business organisations are therefore the main area of study.

While economics examines the entire economic system of a country, business management limits its studies to one component of the economic system: the individual organisation, whether it is a private business, a public corporation or, to a lesser extent, a non-profit-seeking organisation. For example, economics examines the problem of inflation against the background of its implications for the national economy, while business management is more concerned with the effects of inflation on individual businesses.

Critical thinking

Government organisations and private businesses: Servicing the needs of South Africans

In the South African economy, both government organisations and private businesses act as society's need-satisfying institutions.

Students often ask, 'How is it possible that government organisations act as need-satisfying institutions?' and 'How is it possible for government organisations and private businesses to service similar needs?'

The answer to the first question is that government organisations very definitely act as need-satisfying institutions in that they provide an array of both products and services to their citizens. In most cases, these products and services are exchanged for rates and taxes. The key difference between government organisations and private businesses lies, however,

in the fact that private businesses seek to make profits through the fulfilment of society's needs, whereas this is not the case with government institutions.

Regarding the ways that government organisations and private businesses service similar needs, there are two examples that are particularly relevant in the South African situation.

The first example is society's need for a safe and secure environment. South Africa has a particularly high crime rate compared to the crime rates of other developed countries. In response to this, both government organisations and private businesses seek to address society's security needs. The government does this through the provision of policing services, an efficient judicial system and effective facilities for correctional services. In doing this, the government seeks to address society's needs, although not with a profit orientation. At the same time, many business organisations provide products and services to address the security needs of society. Examples of such products include electric fencing, burglar alarms and security gates, while examples of services include private security services, vehicle-tracking and short-term insurance. In contrast to the government organisations, businesses providing these products and services do so in exchange for profits.

Another good example in South Africa is provided by the healthcare system. Both government and private businesses seek to address society's need for healthcare. Government seeks to provide healthcare services to its citizens through public hospitals, clinics and emergency services, without a focus on profit. At the same time, private companies such as Netcare and Mediclinic seek to offer the same services, but with the goal of providing higher-quality services in exchange for profit.

Many more examples exist in South Africa in the areas of education, transport and social security.

1.6.2 The purpose and task of business management

The discussion of the cycle of need satisfaction indicated that the primary human endeavour is to achieve the highest possible satisfaction of needs with scarce resources. This endeavour follows the economic principle, to which every economic system is subject. It follows that any component of an economic system, including a business organisation, is also subject to the economic principle. Where the individual business organisation is concerned, this entails achieving the highest possible output with the lowest possible input of production factors.

The purpose of business management is to produce the greatest number of units of products or services at the lowest possible cost.

From this emerges the task of business management, which is to determine how an organisation can achieve the highest possible output (products and services), with the least possible input (human resources, natural resources and capital). More specifically, the task of business management entails an examination of the factors, methods and principles that enable a business to function as efficiently and productively as possible in order to maximise its profits. In short, it is a study of those principles that have to be applied to make a business organisation as profitable as possible. It may also include a study of the environmental factors that could have an effect on the success of an organisation, its survival or its profitability.

Examples of approaches, principles and methods studied by business management with the purpose of making an organisation function as productively as possible

General approaches to management methods (see Chapters 6 to 10), which have been tested over the years, include the following:

- The mechanistic approach, introduced at the turn of the century, emphasises mass production, especially under the management of engineers.

- The human-relations approach originated in the 1930s and emphasises the motivation of workers.
- The contingency approach of the 1950s argues that the management approach is prescribed by the prevailing situation.
- Strategic management, the most recent approach, makes a special study of how management should act in an unstable environment.

Various supplementary approaches and developments, such as organisation design, the management of change, information management, corporate culture and the management of diversity are still being studied.

In the field of marketing management (see Chapter 13), research into experimentation with approaches and methods has also contributed to the more productive operation of businesses. These include the following:

The marketing concept replaced the production approach in management philosophy to enable businesses to adjust their resources more effectively to the needs of consumers. Market research, as an instrument of marketing philosophy, has developed many methods of studying the needs of consumers.

Methods of studying and determining consumer habits and segmenting markets, as well as strategic management aids, have also stimulated marketing management to higher productivity.

Financial management (see Chapter 14) as an area of business management has also tested many methods, especially financial ratios. The following are some examples:

- Ratios to access the financial performance of businesses;
- Capital budgets and capital-budget techniques, in particular to evaluate potential investment possibilities;
- Approaches to dividend policy; and
- Approaches to and methods of financing growth and expansion as profitably as possible.

In the same way, numerous methods, principles, approaches and problems in other areas of business management (such as production and operations, purchasing, human resources management and external relations – see Chapters 11, 12 and 15) have been researched and tested.

The sum total of this sustained study of, and experimentation with, management approaches and methods, and research on management problems, constitutes the body of knowledge known as business management.

The purpose and task of business management

- The economic principle consists of the human endeavour to satisfy unlimited needs with limited resources. All economic systems are subject to it.
- In a mixed-market economy, a business organisation as a need-satisfying institution is a component of the economic system, and is therefore also subject to the economic principle.
- According to the economic principle, a business organisation always has to endeavour to obtain the highest possible output (products and services) at the least possible input (lowest cost). This is the purpose of business management.
- The business organisation is the subject studied by business management.
- The task of business management is to examine factors, methods and principles that enable a business organisation to maximise its profits and achieve its objectives.

The study of business management entails comprehensive and ongoing research and the examination of management problems, the testing of approaches and principles, experimentation with methods and techniques, and the continuous weighing up of environmental variables. The result is an applied science that indicates how business organisations can best be directed towards realising their objectives.

Therefore, in the case of business organisations, the economic principle is defined as the endeavour to achieve the highest possible income in the market at the lowest possible cost, with profit as the favourable difference between the two. This principle is also applicable to government organisations and non-profit-seeking organisations. The only difference is that in the case of government organisations and non-profit-seeking organisations, the difference between inputs and outputs is not measured in profit, but rather in terms of surplus, savings or higher productivity.

In a business organisation, the economic principle and the profit motive coincide, making profits the driving force, and so the task of business management becomes one of maximising profits. However, this does not mean that the task of business management is to maximise profits at the cost of everything else, especially the well-being of society. In today's business environment, the objective is rather to maximise profits through good management and care of employees, customers, investors and society in general.

To summarise, the task of business management is to study those factors, principles and methods that will lead a business organisation, as a component of the prevailing economic system, to reach its objectives. In a mixed-market economy, this primarily – though not exclusively – means making a profit.

1.6.3 Is business management an independent science?

Business management is a young subject and its scientific basis is still the subject of lively debate. There is no easy answer to the question of whether business management is an independent science, as there are many diverse opinions about what exactly constitutes a science.

The most common definitions of a science emphasise different characteristics. Business management is continually being tested in the light of these characteristics to determine whether it merits the status of a science:

- The most outstanding characteristic of a science is a clearly distinguishable subject of study that forms the nucleus of a discipline.[21] Business management completely satisfies this condition, particularly with regard to the business organisation which, as a component of the market economy, is its subject of study.
- A fundamental characteristic of a science, which supplements the one mentioned above, is that it should be independent of other sciences. As we have already pointed out, business management has its own identifiable subject of study, and from this point of view may be regarded as a science. However, it should be clearly understood that a business organisation can be studied by other sciences for other reasons. People are social animals who organise themselves into groups to fulfil purposes that are too big or too complex for a single individual. A business organisation comprises people who wish to attain certain personal and organisational goals. Business organisations may also, therefore, form a subject of study for sciences such as sociology, psychology and medicine. However, the way in which business management views an organisation is indicated by the purpose of the study. This is to examine those things that may guide businesses as effectively as possible towards their objective, which is primarily to make a profit. This essential characteristic also allows business management to qualify as a science because, unlike other sciences, it is concerned mainly with ways of maximising the profitability of a business.
- A third characteristic of a science is that it is a uniform, systematised body of knowledge of facts and scientific laws, and that its laws and principles are constantly

tested in practice.[22] In this regard, business management encompasses a great deal of systematised knowledge found worldwide in the comprehensive literature on the subject. It also contains numerous rules and principles that may successfully be applied in practice, even though they are not as exact as those in the natural sciences. This leads to the view that management is a normative science, which means that it constantly endeavours to establish norms or guidelines for management with a view to maximising profits.

- It is also said that the final purpose of a science should be to produce a generally accepted theory. In this regard, business management does not yet satisfy the requirements of an independent science. Because of the rapidly changing environment in which business organisations exist, it is doubtful whether this stage will ever be reached. It should also be borne in mind that the involvement of people in the management process and the influence of uncontrollable variables make it difficult, if not impossible, to explain management problems with any single uniform theory.

While it is still debatable whether business management can be regarded as an independent science, this examination at least provides an insight into its nature. To summarise, business management is a young applied science that sets out to study the ways in which a business can achieve its prime objective, which is to make a profit. However, this does not mean that the application of management principles and approaches should always be done in a scientific way, nor does it require that the intuition and experience of managers be summarily dismissed. Successful management is often regarded as an art as well as a science.

1.6.4 The interfaces between business management and other sciences

Throughout the discussion of the scientific status of business management, it was held that the business organisation, as the subject of study, is the most important entity. However, one should bear in mind that businesses are also studied by other disciplines for other reasons.

Business management, in its task of studying and examining those things that help a business to attain its goals as efficiently as possible, constitutes a young, developing science that frequently makes use of the knowledge gathered by other disciplines on the functioning of the business organisation, even though these disciplines may not be interested in the profitability of organisations. In short, business science takes from other disciplines what it can use to help businesses to accomplish their goals.

Many current management concepts originated in other sciences and now form an integral part of the body of knowledge of business management. For example, the concept of strategy was borrowed from military principles; sociological knowledge and principles help explain the behaviour of an organisation; engineering principles are applied to improve productivity in the manufacture of products and mathematical models and computer science are used to help management make decisions. Furthermore, advertising frequently uses psychology, the arts and communication principles and techniques – all, of course, from the viewpoint of profitability.

Table 1.3 provides a self-explanatory exposition of the multidisciplinary nature of business management. In view of the constantly changing environment in which contemporary businesses operate, business management is likely to make more, rather than less, use of other sciences in future.

Table 1.3: Interfaces between other sciences and business-management functions

1.7 Classifying the study material of business management

In order to decide on appropriate study material relating to business management, it is useful to follow a guideline that will offer a broad basis upon which knowledge of business management can be built. This guideline can be formed around questions that arise in response to phenomena that influence costs or profits for the business. This is where the task of management arises: to examine those things that will best improve the profitability of the business organisation to ensure its success.

The various activities that management must undertake to make a business organisation work can also be seen to constitute the field of business management:

- Markets must be researched to determine whether there is a need for a particular product.
- Raw materials must be purchased to produce such products.
- Staff and equipment must be acquired to manufacture the products.
- Money has to be obtained to pay for the materials and the equipment, as well as to remunerate staff.
- These often disparate activities have to be co-ordinated or managed.

To give scientific direction to the study of these interrelated activities, the total field of business management is divided into seven functions. Each function (or management area) comprises all aspects of a specific group of activities. (See Table 1.3 and the discussion that follows.)

The main reason for dividing the field of business management into different functional areas is the need to systematise the large body of knowledge. The multidisciplinary nature of the subject also makes division necessary. The training and skills required for the various functions are highly diverse, and on occasion each function makes use of different disciplines to achieve its management purpose. Financial management makes use of computer science, risk management and accountancy concepts, while human resources management uses a great deal of psychological knowledge and social theory.

Some degree of specialisation in a specific management function is necessary to make management as productive as possible. In this book, however, the functions are distinguished only for analytical purposes, to provide a better understanding of each and to explain its relation to the others.

The function of general management includes an examination of the management process as a whole: the planning that management has to do, the organisation that it has to establish to carry out its plans, the leadership and motivation needed to get things done, and the control that has to be exercised over the whole process. This requires a survey of the different management approaches that may be adopted. General management is the overall function through which top management develops strategies for the whole business. It cuts through all the other functions because they are carried out at the top level as well as in each functional area.

The operations function concerns all those activities that mobilise the resources (such as raw materials, capital and human resources) of a business organisation to create the finished products and services that can be distributed to meet the needs of its customers.

The human resources function entails the management of a variety of activities involved in driving employees within a business organisation to achieve their maximum potential for the organisation and themselves. In so doing, this function guides employees towards the accomplishment of the objectives and vision set out by general management.

The marketing function is responsible for marketing the products or services of the business. This process includes assessing the market and the needs of consumers, as well as developing a strategy to satisfy those needs profitably.

The financial function includes the acquisition, utilisation and control of the money that the business needs to finance its activities, raw materials and equipment in such a way that its profits are maximised without endangering its liquidity or solvency.

The purchasing and supply function is responsible for the acquisition of all products and materials required by the business to function profitably – raw materials, components, tools, equipment and, in the case of wholesalers and retailers, the inventory to be purchased. Purchasing managers have to be in contact with suppliers so that they are aware of new products and know the prices at which products can be bought. They also have to keep inventory up to date in order to ensure continuity of functioning.

Ultimately, the functions form a synergistic whole that directs the business organisation towards its goal and its objectives.

1.8The arrangement of this book

Business management comprises a broad body of knowledge. For logical flow in this book, the body of knowledge has been divided into three parts as follows:

- Part 1: Chapters 1–5;
- Part 2: Chapters 6 –10; and
- Part 3: Chapters 11–15.

Chapter 1, the introduction to business management, has set the scene for Part 1 and the rest of the book. Chapter 2 discusses the entrepreneur and entrepreneurship, while Chapter 3 looks at the establishment of the business organisation in greater detail. The environment within which a business operates is examined in Chapter 4. Chapter 5 addresses the issue of corporate social responsibility.

Part 2 of this book reviews the management process, the developments in management theory and some approaches to management. Chapter 6 introduces general management. Chapters 7 and 8, which examine planning and organising respectively, are the starting point for an examination of the management process. The nature of motivation and leadership in an organisation is discussed in Chapter 9, while Chapter 10 deals with control, the final part of the management process.

The functional areas of a business are examined in Part 3 of the book. Chapter 11 looks at operations management, which concerns the management of the physical production of products and services. Chapter 12 looks at how an organisation can manage what are arguably its most important resources: its employees. Chapter 13 provides an overview of the marketing function and the public relations function of a business. Chapter 14 discusses financial management, investment management and

financing decisions. The last chapter of Part 3, Chapter 15, provides an overview of the purchasing and supply function, as well as the sourcing activities.

1.9 Summary

This chapter has explained the business organisation's role in society. It has also considered the interaction between society and the business organisation as a social process that transforms a country's means of production so that products and services can be produced that will satisfy the needs of society. This process was explained in greater detail in the discussion of a business organisation as a component of the economic system, where it was specifically shown how, as a need-satisfying institution of the market economy, the business organisation provides for the needs of people. Lastly, this chapter examined the task of business management.

Small business perspective

While South Africa is a relatively free economy, and entrepreneurs can generally produce what they want for whom they want to sell to, it is not particularly easy to start a business in South Africa. Here we highlight just three problems that South African entrepreneurs have to deal with.

For one thing, there are several laws and regulations to comply with. The Companies Act (No. 71 of 2008), the Consumer Protection Act (No. 68 of 2008), tax laws and regulations, and the Basic Conditions of Employment Act (No. 75 of 1997) are but a few of the laws, regulations and sector charters with which small businesses have to comply. It can be time consuming and expensive to ensure compliance with all the relevant legislation and regulation.

It may also be difficult to find financing for new business ventures, especially if the entrepreneur does not have assets to offer as security. Banks will offer secured financing if the entrepreneur has assets to offer as collateral, but will be reluctant to provide unsecured lending to start-up ventures. While there are several other funding bodies, it often requires patience and effort from the entrepreneur to go through the rigorous and bureaucratic application processes.

The lack of skilled labour means that skilled employees come at a high cost, which may act as a constraint to the growth and expansion of the new venture. This is just one example of how scarce resources may constrain entrepreneurial ventures, especially in developing countries.

Given the importance of entrepreneurs in fuelling innovation, growth and employment, it is important for South Africa to find ways to make it easier to start and grow small businesses. Currently, South Africa ranks 82 out of 190 countries globally on the World Bank 'ease of doing business' scale,[23] which means that there is still a lot of improvement required in terms of making it easier to set up and operate businesses. The establishment of a government department focusing on small business development is a step in the right direction, although it is not yet entirely clear how this development will benefit entrepreneurs to start and operate small businesses.

KEY TERMS	
business ethics	human resources
business management	industries
business organisation	informal sector

capital	liberal
command economy	market economy
community	market system
competition	Maslow's hierarchy
conservative	mixed economy
consumerism	natural resources
corporate social investment	need-satisfying institution
corporate social responsibility	needs
economic principle	profit
economic problem	resources
economic system	social responsibility
employment equity	socialism
entrepreneurship	stakeholders
environmental sustainability	sustainability
formal sector	transformation

Questions for discussion

Reread the case study on page 3 and answer the following questions:

1.A rail operator is a very different type of business compared to a manufacturing company such as a producer of, for example, processed meats. How might the resources, transformation process and outputs of a rail operator and a processed meats producer differ?

2.What are the factors that determine Prasa's competitiveness?

3.During 2017 and 2018 South Africa's economic conditions were not favourable. What impact do you think this had on the transport industry, and on Prasa in particular? Provide reasons for your answer.

4.In your opinion, how can Prasa turn the business around to become more competitive?

Multiple-choice questions

1.Which of the following statements about socialism is true?

a.There is minimum state interference in markets.
b.The state owns and controls the principal industries such as communication, health services and transportation.
c.People with businesses are free to use their resources as they choose.
d.The state assumes complete responsibility for the production and distribution of products.

2.What is the key purpose of business management?
a.To examine the factors, methods and principles that enable a business to function as efficiently and productively as possible to maximise profits.
b.To produce the highest number of units of products and services at the lowest possible cost.
c.To study, understand and determine how to satisfy the needs of consumers.
d.To identify problems management may encounter and provide solutions for effective management.

3.The description of business emphasises different elements. Which one of following combinations is correct?
i.human activities, production
ii.human activities, production, profit
iii.human activities, production, exchange, profit
iv.production, exchange, profit
a.i
b.ii
c.iii
d.iv

4.Which of the following are contributing factors for dividing the field of business management into different functional areas?
i.The training and skills required for the various functions are highly diverse.
ii.To give scientific direction to the study of these interrelated activities.
iii.The multidisciplinary nature of the subject.
iv.The need to systematise the large body of knowledge.
a.i, ii
b.ii, iv
c.ii, iii, iv
d.i, ii, iii, iv

5.Many micro-enterprises form part of the ________ sector.
a.formal
b.government
c.NGO
d.informal

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CHAPTER 2

Entrepreneurship

Watson Ladzani

The purpose of this chapter

This chapter examines entrepreneurship as the creative and driving force behind the business organisation. It is the entrepreneur who decides what, how, by whom and for whom products and services should be produced to satisfy the needs and wants of society. This chapter examines the nature of entrepreneurship, and the role of entrepreneurs and small businesses in the economy. In addition, it looks at the entrepreneurial process, as well as the different ways of entering the business world: by starting a new business and growing it, by buying an existing business and growing it, by entering into a franchise agreement or through corporate entrepreneurship. Finally, the feasibility of new venture opportunities is discussed.

Learning outcomes

On completion of this chapter you should be able to:

- define the term entrepreneur
- discuss the concept of entrepreneurship and the entrepreneurial process
- describe the roles of entrepreneurs and small businesses in the economy
- explain how to become an entrepreneur
- comment on the skills and resources required to become an entrepreneur
- identify and describe the different ways of entering the business world
- present recommendations regarding the choice of a business opportunity
- elaborate on what a feasibility study is and its value to the entrepreneur.

2.1 Introduction

The previous chapter revealed that the science of business management examines how to improve the performance of a business organisation, and it focused on how business organisations transform a nation's resources into products and services to meet the needs and wants of its people. However, in order to understand how the business organisation satisfies the needs and wants of a nation in a market economy, one needs to understand the driving force behind the business organisation: the entrepreneur.

It is the **entrepreneur** who decides what, how, by whom and for whom products and services should be produced. An entrepreneur is someone who starts a business with the intention of making a profit and assumes the risk of losing all of his or her resources if the venture fails.

Although the terms 'entrepreneur' and 'entrepreneurship' are freely used to describe someone with a small business, or small business enterprise, however, according to various academics and researchers, someone with a small business is not necessarily an entrepreneur and entrepreneurship is not only applied in small business enterprises.[1]

The entrepreneur is the source of one of the four main factors of production discussed in Chapter 1: natural resources (land), human resources (labour), financial resources (capital) and entrepreneurship. Entrepreneurship is the factor that mobilises the other three resources (land, labour and capital) and harnesses them in different combinations to meet the needs and wants of society.

Entrepreneurship is the process of creating and building something of value from practically nothing in the midst of uncertainty and risk, and having the determination to succeed against all odds.[2]

The process of starting a new business, of sometimes failing and sometimes succeeding, is entrepreneurship. Entrepreneurship is constituted by those individuals in society who use their initiative and take the risk of harnessing the factors of production to provide products and services. The entrepreneur's reward for taking the initiative and taking risks is profit. The entrepreneur's punishment for making the wrong decisions is financial loss.

By knowing what drives entrepreneurs, and how they identify and assess business opportunities and enter the business world, the student of business management will have a better understanding of how business organisations function. This is essential even if the student plans to become a manager, as managers play a key role in the success or failure of business organisations, and need to know how the entrepreneurial process works.

2.2 Different concepts of what an entrepreneur is

The first question that arises in the quest for a scientifically based definition of the notion of an entrepreneur concerns identity: who or what is an entrepreneur? Is the owner of a suburban filling station, the local estate agent or the owner of a Nando's franchise an entrepreneur? Are there entrepreneurs in schools, government projects and large enterprises?

There is no hard-and-fast rule here, nor is there a formal classification or register of entrepreneurs. Moreover, scientists have different views on whom or what exactly an entrepreneur is:

- Economists subscribe to the view that entrepreneurs combine different resources in specific combinations to generate products and services so as to make a profit. Their focus is on what entrepreneurs do. Entrepreneurs, to them, are people who are driven primarily by the profit motive.
- Behaviourists (psychologists and sociologists) tend to view entrepreneurs from the behavioural perspective. Psychologists describe entrepreneurs according to their characteristics, for example, the achievement orientation of entrepreneurs and their propensity towards creativity and risk-taking.
- Marxists regard entrepreneurs as exploiters.
- Corporate managers see entrepreneurs as small operators who lack the potential to manage a large enterprise.
- Proponents of a market economy see entrepreneurs as the economic force responsible for the prosperity of a country.

In addition, in the field of management and entrepreneurship alone, writers give differing definitions of what an entrepreneur is. Entrepreneurs have been described as people who:

- are creative (have the ability to produce new and original ideas in order to solve a problem);

- are innovative (use new ideas to develop a better product, service, process or technique);
- identify opportunities (created by the unlimited needs of people and trends that appear in the environment);
- find resources (natural resources, human resources, financial resources and entrepreneurship) to pursue these opportunities for personal gain (profit);
- take financial risks (run the risk of potential loss or failure of the businesses they start);
- bring about change, growth and wealth in the economy (winning nations have entrepreneur-driven economies);
- re-energise economies and create jobs (desperately needed in South Africa); and
- start, manage and grow sustainable small businesses (the owner of a business starts and manages the business and re-allocates the business resources in such a way that the business makes a profit and grows).

An entrepreneur is usually a creative person who scores high on achievement motivation, is willing to take calculated risks and views a challenge as a new **opportunity**. Although the term ‘entrepreneur’ tends to be associated with the founding of a new business or the owning and managing of a small one, an entrepreneur far exceeds this category and cannot only be confined to business enterprise.

The following excerpt adapted from Dollinger (1995: 8–9)[3] shows that the field of entrepreneurship is inclusive of many disciplines as follows:

- The field of entrepreneurship and new venture creation has been approached from many different perspectives and disciplines.
- Historians document entrepreneurial activity and attempt to relate it to the major political and economic events of the ages.
- Anthropologists see entrepreneurship in terms of the development of civilisations. They are interested in issues such as new technology and tool use, the accumulation of surplus capital and its effects on society, and the formulation of entrepreneurial elites.
- Geographers try to find patterns of entrepreneurial activity based on regional and geographic differences. Their goal is to explain these patterns in terms of the natural and physical resources available to the entrepreneurs. They also look at patterns of diffusion of various entrepreneurial activities: technology transfer, organisational innovation, and values and behaviour of entrepreneurs.
- Sociologists view entrepreneurship in two distinct ways. One emphasis is on understanding the origins of groups of entrepreneurs. Therefore, some sociologists focus on how the values and preferences of different groups of people encourage or inhibit entrepreneurial activity. They look at how differences in ethnic and religious orientations influence people to become entrepreneurs. They study the relation between family development and composition and entrepreneurship. The second sociological focus is on entrepreneurial organisations themselves. These sociologists study the population of organisations, the composition of this population, and its density. They are interested in the birth rates and death rates of various types of organisations, and the underlying reasons for the level and changes in these rates.
- Psychologists study individual entrepreneurs. They seek to understand the mind of the entrepreneur and how the entrepreneur makes decisions. Psychologists are interested in personality traits and the personal characteristics of entrepreneurs and how these factors influence both the decision to be an entrepreneur and the success of an individual entrepreneur.

2.3 The renaissance of entrepreneurship

Entrepreneurs throughout the world are stirring up a revolution that is revitalising economies because the establishment of new businesses and the growth of existing ones are responsible for most of the products and services that are changing people's lives. Furthermore, entrepreneurs generate jobs. The traditional providers of job opportunities, namely large enterprises and government organisations, have been replaced by small businesses as the main providers of jobs.

In Europe, more than 90 per cent of businesses are small- and medium-sized enterprises (SMEs) and they contribute more than 53 per cent to the employment sector. In sub-Saharan African countries, SMEs contribute 90 per cent to the employment sector[4].

Worldwide, countries are debating ways and means of addressing the problems of unemployment, poverty and social instability. **Employment** is closely linked to the state of the economy. When there is no growth in the economy, fewer employment opportunities are available. Unemployment and poverty have direct effects on the social instability of any country such as crime, violence and all forms of social unrest.

2.4 Entrepreneurship in South Africa

Growth in the South African economy has declined over the past few decades. In the 1960s, growth of the gross domestic product (GDP) averaged nearly 6 per cent per year. During the 1980s, GDP growth decreased to 2,2 per cent, followed by no growth in the 1990s. In 2006, GDP growth averaged 4,9 per cent, but this decreased again, to -3 per cent, in the second quarter of 2009.[5] Although from 2008 to 2012 the South African economy grew on average by just 2 per cent, in 2014 the GDP grew by just 1,5 per cent.[6] In 2016, the economic growth in South Africa was persistently low (the GDP grew by 0,3 per cent).[7] Trading Economics (2018)[8] reported that GDP growth rate in South Africa averaged 2,78 per cent from 1993 until 2018, reaching an all-time high of 7,60 per cent in the fourth quarter of 1994 and a record low of -6,10 per cent in the first quarter of 2009.

In order to sustain and improve the economic development of the country, a growth rate of over 7 per cent per year in real terms is needed.[9] The contribution of entrepreneurs will be relied on for a large part of the growth needed. While it is the combination of all businesses – small, medium and micro-enterprises (SMMEs) and large national and international businesses – that determines the state of the economy, it is high-potential entrepreneurs who are focused on growing their businesses who are responsible for growth and employment creation in the economy.

There are many reasons for South Africa's high unemployment level, but one reason in particular is the country's labour laws. Statistics reveal that the more flexible the labour market is (the freer it is from government intervention), the lower the unemployment rate is. Another significant reason for South Africa's high unemployment is that South Africa does not have enough businesspeople involved in small businesses to create employment. The current interest in the phenomenon of entrepreneurship is therefore very understandable.

Yet entrepreneurship is a scarce resource, as borne out by the results of the Global Entrepreneurship Monitor (GEM) survey. The Total Early-stage Entrepreneurial Activity (TEA) index is calculated based on this GEM survey, and shows the percentage of people aged between 18 and 64 who are actively involved in starting a business or managing a business that they wholly or partly own and that is younger than three and

a half years old. The GEM survey provides the TEA index to offer useful data on both the extent and nature of entrepreneurial activity in South Africa. While in 2011, South Africa ranked 29th out of 54 countries, with a TEA rate below the average rate of all participating countries, in 2016 South Africa ranked 58th out of 65 economies in terms of entrepreneurial participation by 25 to 34 year olds – a disappointing score that is likely a strong contributor to South Africa's decline in overall TEA, and is cause for grave concern in its implications for future entrepreneurial activity in the country.[10] The decline in South Africa's overall TEA rate for 2016, compared to 2015, is due chiefly to decreased entrepreneurial activity among South African men. The male TEA rate has dropped by 31 per cent, while the female TEA rate has decreased by only 16 per cent, relative to the 2015 figures.[11] When compared with the other BRIC nations, South Africa is by far the smallest in economic input (BRIC is an acronym that refers to a select group of four large, developing countries: Brazil, Russia, India and China.) When South Africa was formally invited to join the group in December 2010, the new grouping became known as BRICS

Since GEM's inception, the Total Early-stage Entrepreneurial Activity (TEA) index has been one of the principal measures of entrepreneurial activity in participating economies. It therefore provides a benchmark for cross-national comparisons as well as longitudinal comparisons within economies. South Africa's performance in terms of relative position – that is, how many positions above or below the median (the middle of a distribution) South Africa ranks – for the years 2002 to 2015. It is clear that in 2016 South Africa's overall ranking is significantly below the median for the GEM sample, and considerably worse than for 2015. Since 2014, TEA activity in South Africa (relative to the GEM sample as a whole) has demonstrated a persistent downward trend but has shown an improvement in 2017.[12]

The rates of all levels of early-stage entrepreneurial activity dropped significantly between 2013 (10.59%) to 2014 (6.97%), but have risen in 2017 to 10.96%. Figures for 2017 for other sub-Saharan countries are not available.

However, South Africa has many successful entrepreneurs. Although the term 'entrepreneur' is associated with founding a new business or owning and managing a small one, this does not mean that entrepreneurs are not found in large corporations. In fact, most of South Africa's large corporations had humble beginnings in the hands of people who went on to become illustrious entrepreneurs. The following people are well-known entrepreneurs in South Africa and abroad:

- Ernest Oppenheimer – started Anglo American in 1917;
- Anton Rupert – founder of Rembrandt, Remgro and Richemont;
- Raymond Ackerman – founder of Pick n Pay;
- Patrice Motsepe – African Rainbow Minerals, Armgold;
- Tokyo Sexwale – Mvelaphanda Holdings;
- Mark Shuttleworth – Thawte;
- Annetjie Theron – founder of the Annique skin care and cosmetics range;
- Bill Venter – Altech and Altron;
- Herman Mashaba – founder of Black Like Me;
- Cyril Ramaphosa – founder of Shanduka;
- Ferdinand Chauvier – developed the Kreepy Krauly pool cleaning product;
- Mark Zuckerberg – founder of Facebook;
- Richard Maponya – owner of Maponya Mall, Soweto's first mega-regional upmarket shopping centre, which opened in 2009;

- Dr Thabang Molefe, winner of the 2008 Shoprite/Checkers Business Entrepreneur Woman of the Year Award;
- Basetsana Kumalo – launched her own clothing, eyewear and cosmetic range;
- Sizwe Nzima – founder of Iyeza Health, the specialist health logistics service that delivers chronic medical services;
- Leah Molatsela – offers digital legal services to people from all over the county;
- Ronnie Apteker – founder of the first Internet service provider, Internet Solutions; and
- Sol Kerzner –founder, chairman and CEO of Kerzner International.

An example of such an entrepreneur appears in the case study below. This case study shows how a South African entrepreneur, Adam Ismail Ebrahim, managed to raise seed capital to start his own business, an investment company called Oasis Group Holdings. At first, he appointed too many employees at too high a cost, but he managed to set this straight. In spite of many restrictive rules pertaining to investments in his market, he managed to identify investments complying with the requirements of his clients. His Cape Town-based business then became very profitable, and by 2008 it had two overseas branches – one in Dubai and one in Dublin.[13]

CASE STUDY: Entrepreneurship in action: Exploiting restrictive rules

Buying shares in a company run by one of the finalists in the 2006 World Entrepreneur Awards helped finalist Adam Ismail Ebrahim – CEO and CIO of Oasis Group Holdings – fund his company.

'In 1997 – when I realised that my time as an employee was coming to an end – I sold shares that I had bought in Naspers a year before its listing at R1,45, for R50,' says Ebrahim, whose brothers, Mohamed Shaheen (chairman) and Nazeem (deputy chairman), pooled resources with him to start an investment company.

They wanted to provide a particular service not previously offered to Muslims, both in terms of savings and retirement. Muslims have the dilemma that their religious rules prohibit them from benefiting from the proceeds of companies involved in alcohol, tobacco, financial services, entertainment and pork products as well as companies that are highly leveraged. The use of derivatives is also prohibited.

Oasis began with seed capital of R3 million, with a strong focus on developing the niche market of investments that complied with Shariah religious law. It has since grown to be the leader worldwide in Shariah-compliant investments. Both its global funds were rated AA by Standard & Poor's and its Crescent Global Fund received a five-star rating from MorningStar.

Ebrahim, who hails from District Six, holds a BSoc (Hons) from UCT. He later studied accounting, completed his articles at Deloitte and was seconded to the firm's London office in September 1986.

'It was an interesting time, with new regulations being implemented in the financial-services sector. On top of first-hand experience of changes in the regulatory environment, I witnessed the stock-market crash the following year,' says Ebrahim, who gained insight into the world of investment while witnessing the contrast between 'absolute euphoria caused by booming market conditions and utter depression' when the tide turned.

He returned to South Africa in 1988 and joined Allan Gray as an analyst, but was soon promoted to being the partner responsible for training managers. 'Until 1996 things went very well, and I felt that I was living my dream,' says Ebrahim, who later found it 'increasingly difficult' to get motivated by his environment.

'When I resigned to start out on my own, Allan Gray offered to fund my business. However, I felt that it would be inappropriate and that I wouldn't really be independent. I wanted the freedom to paddle my own boat, to follow my own philosophy and target untapped markets with my own resources. Thus, we became competitors after I had eight good years with Allan Gray, gaining confidence and an understanding of the industry.'

‘But then I made a huge mistake,’ says Ebrahim. ‘I believed people who made promises of vast amounts of money that they’d invest in the new business. On the strength of that I made the next mistake: I hired 16 people – six being highly paid CAs.’

‘We had no revenue, no assets, an expensive salary bill and a very expensive cost structure – and the losses just kept mounting. To make matters worse, two weeks after getting our first institutional client, markets were hit by the Asian crisis. I know it has since become a sensitive image to use, but it was like a toddler taking his first steps along the beach just when a tsunami hits … ‘.

‘But we survived – on the foundations of an investment philosophy of no volatility, which, combined with our ethical offering, proved to be a very definite and successful niche.’

‘I fired everybody after realising they were having a ball doing nothing. We started managing the money we did have very strictly, our performance improved, losses disappeared and the company – and each of its operating subsidiaries – has never made a loss again,’ says Ebrahim.

‘After having made every mistake possible, and having learnt very expensive lessons, performance started picking up and we decided to enter the retail market, which provided the breakthrough the company needed. People started coming to us, whereas before we had to call on people trying to convince them to invest R300 a month. Up to 65 per cent of our sales were based on that direct model, which has led to our having the lowest churn ratio in the industry and proving how important personal relationships are in business. We now have 30 000 direct retail clients.’

The Oasis Crescent Equity Fund, its flagship fund, has been the best performing equity fund since its inception in August 1998: In the fourth quarter of 2018, the fund size was 5.3 billion rand.

December 2000 was another landmark for the group, when it registered its first global fund, the Crescent Global Equity Fund. That has since established it as the world’s best performing Shariah-compliant equity fund.

The retail retirement business was launched in 2002, providing all investors access to Shariah-compliant and ethical retirement savings not previously available. ‘We find that 30 per cent of our clientele aren’t Muslims,’ says Ebrahim. Oasis also launched the first Shariah-compliant prudential unit trust in April 2005 and the first listed Shariah-compliant property fund in November 2005.

Ebrahim ascribes the success of the business – Ebrahim received the Champion Award for Asset Management at the 2018 GIFA Awards – to an owner-based culture and adherence to global regulatory and ethical standards. He says the Oasis model is also built on selling a product tailored to what people need and not so much on what they want, a result of building up a personal relationship with a client.

Oasis has more than R25 billion of assets under management and employs 140 people in South Africa and Ireland. Through a joint venture in Malaysia, the group has exposure to Singapore, Indonesia and Brunei. The Oasis head office is based in Cape Town.

In February 2007, Oasis opened associate offices in Dubai. In that same year, Oasis reached the US$4 billion mark in assets under management. In June 2007, it celebrated its tenth birthday. In February 2008, Oasis opened its office in Dublin to further the growth of its global portfolio-management capabilities. It continues to expand its product range.

Sources: Oasis. 2018. Quarter 4, 2018. Available at http://www.oasis.co.za/default/content.aspx-?initial=true&moveto=839; Adapted from Naudé, C. 2006. Exploiting restrictive rules. *Finweek*, 9 November, pp. 69–70. Reprinted by permission of Gallo Images/IMAGES24.co.za/Finweek.

2.5 The role of entrepreneurs and small-business owners in society

Chapter 1 described how businesses owned and driven by entrepreneurs satisfy needs and wants by mobilising a country's natural, human and financial resources to produce much-needed products and services. In the process, wealth is created for society (in the form of jobs) and for the entrepreneur (in the form of profits). Entrepreneurial activity is the essential source of economic growth and social development, and the key role played by this factor of production was underestimated for many decades. Entrepreneurship is the spark that brings the other factors of production into motion. However, it is also imperative to realise that entrepreneurship is in turn mobilised by the self-efficacy, creativity, skills and expectations of individuals. If the entrepreneurial spirit is absent, the production machine does not go into action.

People with entrepreneurial talents and skills and an entrepreneurial orientation are able to achieve more than others in mobilising productive resources by starting enterprises that will grow. People with entrepreneurial qualities are rare and valuable. They constitute a resource that greatly contributes to, if not causes, the production of products and services. They set in motion the creation of employment opportunities.

There is a distinct difference between entrepreneurial businesses and some, or perhaps even the majority of, small, medium and micro-enterprises (SMMEs), which are not entrepreneurial. SMMEs often exist as a way of earning income that is an alternative to working as an employee. They satisfy their owner's need for independence or lifestyle needs. True entrepreneurs differ dramatically from **small-business owners** who are satisfied with some autonomy and earning a reasonable income for themselves and perhaps a few employees, but who have no intention of growing and developing their business entrepreneurially. Therefore, not all small businesses are entrepreneurial.

Mr Ebrahim, the subject of the case study on page 49, is a true entrepreneur. He not only started his own business in 1997, but also managed to grow it over fewer than ten years to become a medium to large business, and he still remains entrepreneurial. He continuously adds new products, such as the Oasis Crescent Equity Fund in 1998, the Crescent Global Equity Fund in 2000, Oasis's retail retirement business in 2002, and a prudential unit trust as well as a property fund in 2005. By 2018, the company had over 40 funds including various equity, property and retirement funds.

However, while high-growth entrepreneurs are vital for any economy, this does not mean that entrepreneurial SMMEs are not important. In South Africa, the sector including SMMEs comprises about 95 per cent of all enterprises, accounts for almost 75 per cent of employment in the country and contributes approximately 56 per cent to the country's GDP.[14]

In the United States, small businesses employed 58,9 million people, or 47,5 per cent of the private workforce, in 2018. Businesses with fewer than 100 employees have the largest share of small business employment, as shown in Figure 2.1.

Figure 2.1: United States employment by business size (employees)

Source: US Small Business Administration. Office of Advocacy. 2018 Small Business Profile. Available at https://www.sba.gov/sites/default/files/advocacy/2018-Small-Business-Profiles-US.pdf.

Cognisance should be taken of the fact that the definition of a small business can vary from country to country. In South Africa, the National Small Business Amendment

Act (No. 29 of 2004) defines a small business as a company with a labour force of fewer than 50 employees.[15] In developed economies such as the United States, small businesses are defined as businesses that employ up to 500 people.

2.6 Why do entrepreneurs do what they do?

As well as examining what an entrepreneur is and what an entrepreneur does, a succinct overview of why entrepreneurs enter the world of business will add to an understanding of the complex concept of entrepreneurship. However, a full understanding of why entrepreneurs do what they do has eluded researchers for many years. Comparative studies have indicated that roughly one-third of a nation's people enter into business, while the other two-thirds are professionals, government employees, employees of businesses and the unemployed. But what is it about the entrepreneur that causes him or her to enter into the world of business?

The decision to enter into business is influenced by many variables, which differ from country to country. However, three broad categories of reasons for individuals initiating ventures are their traits and characteristics, their skills and industry **experience**, and the opportunities arising owing to international trends towards outsourcing.

2.6.1 Entrepreneurs' traits and characteristics

The following **traits** and **characteristics** are typical of entrepreneurs.

2.6.1.1 Achievement motivation

The most researched and possibly the most essential trait of an entrepreneur is **achievement motivation**. In pioneering studies by the researcher David McClelland,[16] entrepreneurs are described as people with a higher need to achieve than people who are not entrepreneurs. Achievement motivation is characterised by actions of intense, prolonged and repeated effort to accomplish something that is difficult. The person with achievement motivation will also work single-mindedly towards his or her goal and will have the determination to win and to do everything well. He or she will enjoy competition.

Achievement motivation goes hand in hand with ambition and competitiveness. People with a high need to achieve are attracted to jobs that challenge their skills and their problem-solving abilities. They avoid goals that they think would be almost impossible to achieve or ones that would guarantee success. They prefer tasks in which the outcome depends upon their individual efforts. An entrepreneur or would-be entrepreneur's high need for achievement also includes the following other needs:

- The need to be personally responsible for solving problems;
- The need to set one's own goals and reach these goals through one's own efforts;
- The need to have feedback on the degree of success with which tasks are accomplished;
- The need to have personal accomplishments; and
- The need to have control over one's own time, and to use time and money creatively (entrepreneurs who start a new business usually desire independence and do not want to be controlled by someone else).

From the case study, it is clear that Mr Ebrahim of Oasis Group Holdings has a need for achievement. Once he had reached his dream of becoming a partner in Allan Gray, he realised that he had other goals to achieve and started his own business. He demonstrated a definite need to be independent by refusing funding from his former employer. He used his own time and money (resources) to enter a new market, which is

evidence of his ability to identify an opportunity. He wanted the freedom 'to paddle [his] own boat, to follow [his] own philosophy and target untapped markets with [his] own resources'.

2.6.1.2 An internal locus of control

The second significant characteristic of an entrepreneur is a strong internal locus of control as opposed to an external locus of control. An **internal locus of control** indicates a person's need to be in charge of his or her own destiny, whereas an external locus of control indicates that a person believes that the outcome of an event is primarily out of his or her personal control. People with an external locus of control regard luck and fortune, rather than personal ability and hard work, as the reasons for success. People with a strong internal locus of control believe that the outcome of an event is determined by their own actions. They believe that they have control over their own behaviour, are successful in persuading and motivating other people, actively seek relevant information and knowledge, are well informed about their careers, perform well on skills-related tasks and process information efficiently. Luck, chance or fate is therefore of little relevance to an entrepreneurial personality.

In the case study, Mr Ebrahim clearly acknowledged his own mistakes, including believing people's promises and hiring a workforce that was too expensive. He took personal control by getting rid of superfluous employees, by starting to manage the company's money personally and by initiating an investment policy of no volatility.

2.6.1.3 Innovation and creativity

Successful entrepreneurs and owners of small businesses are innovative and creative. **Innovation** helps existing businesses to improve the way their products and services are made and delivered, or to introduce entirely new ones to the market. Entrepreneurs identify opportunities in the marketplace and visualise creative new ways to take advantage of them. Innovation is usually included in any definition of creativity. Although not all entrepreneurs develop new products or services, or discover new resources, every person who establishes an enterprise, and who adds value and ensures that an enterprise continues to exist (thereby developing job opportunities) is involved in economic creation.

Creativity refers to the creation of something new – for example, the creation of a new business by developing a new product or service, building an organisation by financial manipulation, reshaping an existing business, or creating a business that will survive on its own and generate a financial fortune as testimony to the entrepreneur's skill. Basically, creativity involves new ideas, and any application of these new ideas is based on innovation.

However, as well as involving the identification of opportunities and solutions, creativity can also involve the adjustment or refinement of existing procedures or products. Although entrepreneurs understand the importance of innovation, they often view the risk and the high investment that the development of innovative products or services requires as being out of proportion to the potential profit. This explains why entrepreneurs often creatively adapt innovations of competitors by, for example, product adjustments, imaginative marketing and client service. Thus, their creativity finds expression on the continuum of innovation and adaptation.

From the case study, it follows that Mr Ebrahim had the ability to be innovative. He developed a savings and retirement service, an equity fund, a prudential unit trust and a property fund not previously offered to a particular target market, namely Muslim people. By ensuring compliance to Shariah religious laws (which prohibit Muslim

people from benefiting from the proceeds of companies involved in alcohol, tobacco, financial services, entertainment, pork products, high-leverage operations and the use of derivatives), he made it possible for this target market to save and invest for retirement.

2.6.1.4 Risk-taking

Most researchers agree that entrepreneurial behaviour involves the taking of risks in one way or another. In the business world, many variables such as interest rates, currency fluctuations, new laws and so on are beyond the control of the entrepreneur. The successful entrepreneur correctly interprets the risk situation and then determines actions that will minimise the risk; he or she does not take chances, but sometimes feels it is necessary to take **calculated risks**. Unsuccessful entrepreneurs, in contrast, do not take any risks, or they take expensive, impulsive decisions that they do not think through. Entrepreneurs investigate the critical variables of the situation and calculate the probable results before they take decisions. Successful entrepreneurs avoid opportunities where there is a high probability that they will be unsuccessful, regardless of the reward.

Entrepreneurs manage the risk of their enterprises by accepting control and being involved in the basic aspects of the enterprise. They control their enterprises by getting access to information. They reduce their exposure to financial loss by involving investors, often with the risk of losing control. They shorten the time between the conceptualisation of an idea and availability of the product or service in the market. This is one way of limiting the risk of competition.

The conclusion can be drawn that, before embarking on a venture, successful entrepreneurs take calculated risks based on applicable research, the analysis of information and the investigation of the probable results of an opportunity. As part of this process, they undertake tasks such as feasibility studies, market research, and research and development.

In the case study, Mr Ebrahim knew that he had experience in the business that he planned to pursue. He was also willing to invest his own money (by the sale of his shares in another company) as well as money provided by his brothers (who were to become shareholders in the business). He determined the cost, his available funds and his own knowledge before starting the business. Yet this was not sufficient proof that the business would be a success. He first had to learn various other lessons in the business before he became successful. The establishment of any business involves some risks. Personal mistakes, as well as environmental factors such as volatile financial markets, contributed to the risks of Oasis Group Holdings, but Mr Ebrahim overcame them through entrepreneurial skills and knowledge of the industry.

2.6.1.5 Other traits

The other traits of entrepreneurs include high levels of energy, confidence, future orientation, optimism, the desire for feedback, high tolerance for ambiguity, flexibility/adaptability, passion, commitment and determination, opportunity orientation and motivation to excel.

2.6.2 Entrepreneurs' skills and industry experience

Some people can exploit opportunities more successfully than others. Skills and knowledge, an identified opportunity and the quest for independence are among the most significant reasons for people becoming entrepreneurs. Experience, training and education in a specific field contribute to the success of an entrepreneur in identifying an opportunity, establishing a business and managing it.

Job termination and job dissatisfaction can also lead people to become entrepreneurs. In South Africa, the experience of being unemployed may trigger some people into becoming entrepreneurs. These entrepreneurs are known as **necessity entrepreneurs** and are usually less successful than **opportunity entrepreneurs**.

The 2016/2017 GEM South Africa Report[17] describes necessity- and opportunity-based early-stage entrepreneurial activity as follows:

- Necessity-based early-stage entrepreneurial activity: This is defined as the percentage of those involved in early-stage entrepreneurial activity who claim to be driven by necessity (having no better choice for work) as opposed to opportunity. This is also described as survivalist-driven motivation.
- Opportunity-based early-stage entrepreneurial activity: This is the percentage of those involved in early-stage entrepreneurial activity driven purely or partly by opportunity, as opposed to finding no other option for work. This includes taking advantage of a business opportunity or having a job but seeking a better opportunity.

Entrepreneurship is not necessarily an opportunity for the unemployed because only a few unemployed people have the four main factors of production: natural resources (land), human resources (labour), financial resources (capital) and entrepreneurship. Experience, access to resources and an identified opportunity (which usually comes with experience and exposure in business) are essential for successful entrepreneurship. For example, Mr Ebrahim is qualified in accounting and knew the financial-services sector well owing to extensive exposure and employment in it for ten years. He also had access to capital (his own savings in the form of shares and the savings of his brothers) and, most importantly, he had the desire and ability to create a new business instead of continuing to be employed.

2.6.3 Opportunities arising owing to outsourcing

Outsourcing occurs when work is done for a company by people other than the company's full-time employees.[18] For example, SABMiller previously used large trucks to distribute the beer that the company brewed to customer outlets. Now the distribution of beer has been outsourced to owner-drivers of trucks. Drivers and employees of SABMiller were empowered to purchase trucks and set up their own businesses. They receive contracts from SABMiller to deliver beer to clients in demarcated areas.[19]

Outsourcing usually takes place when a company defines activities that can be completed by other companies that are particularly skilled at and experienced in completing such activities. In cases where the other company could not deliver a better-quality activity, but the same quality of activity, outsourcing would be considered if the activity could be delivered at a lower cost.

Government departments, government organisations and large businesses outsource many of the services and components they need. In this way, they reduce personnel costs and gain access to special skills. In this process, once again, entrepreneurs play a critical role. They are responsible for the formation of new businesses, to which non-core functions are outsourced, often taking over or buying sections of larger organisations that would otherwise have been closed down.

According to a survey conducted in the United States by the International Facility Management Association,[20] the services that are most often outsourced are (in order):

- architectural design;
- trash and waste removal;

- housekeeping;
- facility systems;
- landscape maintenance;
- property appraisals;
- major moves;
- hazardous-materials removal;
- major redesigns;
- furniture moves; and
- food services.

Outsourcing is seen as part of a company's strategic plan. The reason for outsourcing services, according to most of the facility managers, is to acquire specialty skills that are unavailable in-house or are not cost-efficient to handle in-house. Furthermore, they outsource services so that they can focus on their core competencies. Other reasons to outsource include acquiring access to specialty tools and equipment, adding flexibility to work fluctuations, enhancing quality and improving customer satisfaction.[21] In South Africa, owing to labour laws and other complicated issues in the environment, human resources functions are often outsourced.

2.6.4 Other reasons for entrepreneurship

While employees of large businesses are often laid off, SMMEs continue to be established and to grow. Retrenched employees either become self-employed or become employed by new SMMEs that are formed when large businesses sell off some of their sections to function as SMMEs. For example, three employees of a large mining group that unbundled bought two mines that would have been closed down. They had experience in the mining industry, developed a plan, took some risks, started off with a loan, took over the operations, restructured and made some crucial changes. They have been extremely profitable, are growing, and are in the process of buying additional mines and providing employment to many. The worldwide privatisation of government organisations has also resulted in employees becoming entrepreneurs.

While the brief overview above gives some of the main reasons for people becoming entrepreneurs, it does not cover the exhaustive list that may be found in many textbooks. It must also be remembered that entrepreneurs and owners of small businesses come in every shape, size and colour, and from all backgrounds.

2.7 The entrepreneurial process

Entrepreneurship is the process of identifying, creating or sensing an opportunity where others do not see it, and of finding and combining resources (often owned by someone else) to pursue the opportunity until it becomes a successful established business. Of the thousands of business ventures that entrepreneurs launch every year, many never get off the ground, while others have a spectacular start. Much of the success in establishing a new business depends on how well the entrepreneur has done his or her homework.

This is a difficult process because the range of problems and options confronting the entrepreneur is vast, and differs from one opportunity to the next.

For example, although Holiday Inn and City Lodge compete in the same industry, they did not evolve in the same way. Their room rates and the range of services available to customers differ.

The options that are appropriate for one entrepreneurial venture may be completely inappropriate for another. Entrepreneurs must make a bewildering number of decisions – and they must make the right decisions, or their businesses will perish.

By following a scientific decision-making framework, as illustrated in Figure 2.2, the entrepreneur has a better chance of success. This framework or entrepreneurial process of entering the business world follows a logical sequence and clarifies many of the questions the entrepreneur is faced with.

The **entrepreneurial process** involves the following steps or phases to be resolved or worked through:

- The personal characteristics, abilities and skills of the new owner of a business have a profound influence on the success or failure of the new venture. Before entering the business world, any potential entrepreneur should first clarify whether he or she has what it takes to do so.

Figure 2.2: The entrepreneurial process: A framework for decision-making about new ventures

- Another key factor in the creation of a new venture is the question of resources, or rather access to resources. Without access to entrepreneurship and the financial, natural and human resources necessary for the establishment of a business, the new venture is doomed.
- A critical aspect of the entrepreneurial process is the realistic and objective assessment of the opportunity that the entrepreneur is pursuing.
- Once the opportunity has been identified and defined, the entrepreneur needs to find out if it can be turned into a successful venture. This calls for a feasibility study.
- When the entrepreneur has some certainty about the **feasibility** of the venture, he or she needs to compile a **business plan**.
- After the feasibility has been established and the resources have been acquired, the entrepreneur must launch and manage the new business.

These phases of the entrepreneurial process can also be perceived as a framework for decision-making. In each of the phases in the process, the entrepreneur is faced with many questions that must be clarified before he or she can proceed to the next phase.

Yet this framework does not guarantee that a new venture will be successful. Rather, it provides a logical sequence of steps or phases in the entrepreneurial process. In each phase, there is a multiplicity of issues that need to be carefully assessed if the new idea is to be implemented successfully.

Figure 2.3 summarises the dynamics of the entrepreneurial process. The entrepreneurial process is the creation of new value through the entrepreneur identifying new opportunities and using his or her leadership skills to build an organisation that fits the opportunity, and attracts and manages a configuration of resources with the focus on exploiting the opportunity.[22] During this dynamic process, the entrepreneur continuously learns through success and failure.

Figure 2.3: The dynamics of the entrepreneurial process

Source: WICKHAM, PHILIP A., STRATEGIC ENTREPRENEURSHIP, 4th Ed., ©2006. Figure 10.4, p. 228. Reprinted by permission of Pearson Education, Inc., New York.

From this process, entrepreneurial behaviour, characteristics and/or skills that contribute to success may become apparent.

The sections that follow offer a closer examination of the first four phases of the entrepreneurial process.

2.7.1 Skills required for entrepreneurship

A skill is simply knowledge that is demonstrated through action. Potential entrepreneurs therefore need knowledge about the particular environments and industries in which they want to operate, plus considerable management skills, such as the following:

- **Strategy skills** involve the ability to consider the business as a whole and to understand how it fits within its marketplace, how it can organise itself to deliver value to its customers and the ways in which it does this more effectively and efficiently than its competitors.
- **Planning skills** involve the ability to consider what the future might offer, how this will impact on the business, and which resources and actions are necessary to prepare for it.
- **Marketing skills** involve the ability to evaluate the offerings of the business and their features, to determine how they satisfy customers' needs and wants, and to establish why customers find them attractive. Marketing skills also involve the pricing, promotion and distribution of the products or services. In the case study on page 49, Mr Ebrahim invested in a model of direct selling based on a personal relationship with investors. This model ensured the lowest churn ratio in the investment industry, resulting in 30 000 direct retail clients. The product was tailored to the needs of the people and not so much to what they wanted. This was determined by Oasis through personal relationships with clients.
- **Financial skills** involve the ability to manage money – to be able to keep track of expenditure and to monitor cash flow – and to assess investments in terms of their potential and their risks.
- **Project management skills** involve the ability to organise projects, to set specific objectives, to draw up schedules and to ensure that the necessary resources are in the right place at the right time, in the right quantity and the right quality.
- **Human relations skills** involve the ability to deal with people, and include leadership skills, motivational skills and communication skills.

All of these management skills are needed in entrepreneurship, and the more favourably a person is endowed with these skills, the greater his or her chances for success. These skills are discussed in Parts 2 and 3 of this book.

2.7.2 Resources needed to start a business

An entrepreneur must have adequate resources to start a business, or he or she must have access to resources to be able to enter into business. In many ventures, entrepreneurs do not necessarily want to own the resources that will enable them to start a business, but they may seek control of the resources they use. The emphasis is therefore not on which resources the entrepreneur owns, but rather on the access to and control of resources he or she has.

Entrepreneurs acquire resources from the economy and transform these into need-satisfying products and services for the community. Resources are therefore the inputs

that the business combines to create the outputs it delivers to its customers. In broad terms, there are three kinds of resources that entrepreneurs need to build their ventures: financial resources, human resources and operating or physical resources.

An opportunity can be exploited only if the entrepreneur has money or has access to money. **Financial resources** can take the form of cash, a bank overdraft, loans, outstanding debtors or investment capital. Financial resources include basic resources that can readily be converted into cash.

Human resources are people such as the management team, lawyers, accountants, and technical and other consultants. Human resources are people with knowledge and skills who contribute to the success of the venture.

Operating resources or physical resources are assets such as offices, vehicles, equipment, raw materials and, in the case of larger small businesses, buildings, machinery and the plant.

Prospective entrepreneurs must realise that the acquisition of resources implies risk, especially if the expected profits and return on investments do not materialise. If the entrepreneur has used his or her savings to finance the business or used his or her house as security against a loan, that entrepreneur is the one who carries the risk and who stands to lose the savings or the house if the venture is unsuccessful.

If using investors as a source of finance, prospective entrepreneurs must know that investors always compare alternative investments with the anticipated return on the investment and the risks involved.

Although a prospective entrepreneur may have the right experience and the right personal traits to become an entrepreneur, he or she cannot successfully exploit an opportunity without the necessary resources or without access to these resources. This is the most difficult hurdle to cross in becoming the owner of a small business.

2.7.3 Business opportunities

Establishing a new business usually involves an idea that the entrepreneur pursues enthusiastically. Finding a good idea is therefore the first step in converting an entrepreneur's creativity into a business opportunity. The danger, however, is that the attractiveness of the idea is often overrated. In other words, having the best idea is by no means a guarantee of success. Unless the entrepreneur has the capacity and capability to transform the idea into a product or service that captures a significant share of the market, the idea is of little value.

But where do new ideas for a business start-up come from? Research in both the United States and other countries points to the fact that prior work experience, an understanding of the industry and knowledge of the market account for most new venture ideas. For example, in the case study on page 49, it was clear that Mr Ebrahim had extensive experience in the financial services industry and he also had a very good knowledge of the market, namely the people of the Muslim community and their needs, as well as the Shariah restrictions that apply to them. This knowledge and experience resulted in 70 per cent of Oasis clients being Muslims bound by Shariah.

The scientific way to search for ideas involves a thorough search of the business environment for ideas and patterns that emerge from various environmental trends. The business environment is examined in more detail in Chapter 4.

2.7.3.1 New venture ideas

The environment referred to includes everything that happens around the entrepreneur. Trends in the environment include economic, political and **social trends**,

fashions that change over time, new ways in which products are distributed, new services that are offered and so on.

Topical trends in South Africa include economic and social trends:

- When the exchange rate favours foreigners (that is when the rand is weak against the dollar, pound and euro), this makes South Africa a very attractive tourist destination and most activities associated with tourism could provide entrepreneurial opportunities.
- The high unemployment rate combined with a police force that appears incapable of enforcing the law results in violent crime being rampant in South Africa. This fact threatens, for example, foreign investment and tourism, but offers many ideas and opportunities for the protection of individuals and their property. It has resulted in a high demand for the services of businesses that install burglar bars, security fences, security gates, alarm systems and security services such as guards.
- Changing social trends over the past decade have contributed to changing food consumption and distribution patterns, and the outcome is a proliferation of fast-food outlets and pubs.
- Among the new services that have sprung up in the wake of privatisation of government organisations are mail and courier services.

In searching the environment for entrepreneurial ideas, entrepreneurs must remember that industries, like fashions, go through various life-cycle stages, as Figure 2.4 illustrates.

Figure 2.4: The life-cycle stages of industries

Source: Adapted from Ryan, J.D. 1989. *Small Business: An Entrepreneur's Business Plan*. Second edition. Mason, OH: South-Western Cengage, p. 32.

Virtually everything changes according to a **life cycle**, going through the stages of introduction (embryo), growth, maturity and decline. When examining a new venture idea, it is important to know which stage the relevant industry is in, because a different strategy is needed for each stage.

Industries in the maturity stage are, for example, very competitive, resulting in high marketing costs. It is clear from the life-cycle diagram that the car (automobile) industry as a whole is very mature. Nonetheless, some of its segments are in a developing phase, for example, mini-vans, sports models and upmarket imports. Convertibles are back in fashion, and in the suburbs young mothers drive around in 4 × 4s. Despite increasing traffic jams, people still drive, and the cars they drive reflect changing lifestyles.

Where can you find gaps in the life-cycle diagram in Figure 2.4? Ideas can be generated at any point in the life-cycle stages of industries. They may emerge even in those industries that fall into the decline category. This is evident from the revival of cigar smoking. There is even a magazine in South Africa that specifically targets cigar smokers. In addition, hula hoops are making a comeback.

South African industries can also be classified into the categories that appear in Figure 2.4, but prospective entrepreneurs should take a close look at the following industries, which could, in the African landscape, be labelled growth industries:

- **Education.** The government's main priority is to educate all South Africans. Proof of this is the fact that the budget for education comprises the largest portion of the annual budget. The importance of education, combined with the inability of government to reach its educational objectives, has resulted in many opportunities in private education, from elementary education to technical and tertiary education.
- **Healthcare.** Most government hospitals perform poorly. Thus, numerous opportunities exist for entrepreneurs to start healthcare ventures, especially home healthcare. In addition, opportunities such as the development of generic medicine and other healthcare products can be pursued.
- **Tourism.** This has the potential to provide thousands of new jobs. Very little start-up capital is needed to become a tour guide, for example, or to establish a bed-and-breakfast in an existing personal residence. South Africa is becoming a destination for international conferences and sporting events, which opens up many opportunities. Examples include academic conferences, visits by international sports teams and the 2010 Soccer World Cup.
- **Privatisation of government and semi-government services.** Worldwide and in South Africa, government services are being privatised. Entrepreneurs have the opportunity to acquire these organisations or parts of them.

Other sources of ideas include advertisements, retailers, competitors, trade shows, industry associations, contracts, consultants, patents and research institutes. The creative ability of the prospective entrepreneur is imperative in the generation of new ideas. A truly creative person will find useful ideas in a variety of different ways and by various means. Ideas, however, have to be transformed into opportunities if they are to result in the creation of small businesses.

2.7.3.2 New venture opportunities

Good ideas can be turned into successful new ventures. However, a good idea is not necessarily the same thing as a good opportunity. It may be a good idea, for example, to freeze a swimming pool during the short South African winter to save pool chemicals and to provide a home ice rink for children. But the idea cannot be transformed into a new venture opportunity because research has shown that South African pool owners do not find the idea persuasive as pool surfaces are too small. Moreover, because of the costs involved, the idea is not feasible.

A good idea is also not necessarily a good investment opportunity. Many people tend to become infatuated with an idea. They underestimate the difficulty involved in developing it into a product or service that will be desirable to the market. Ultimately, the market determines whether an idea has potential as an investment opportunity.

The following are some of the fundamental requirements for a good investment opportunity:

- There must be a clearly defined market need for the product or service. The most successful entrepreneurs and investors are market focused; they start with what customers and the market wants, and they do not lose sight of this.
- The opportunity must be able to achieve a sustainable competitive advantage.
- The opportunity must have the potential to grow.
- The opportunity must be rewarding to the investor and/or the entrepreneur.
- The timing of the opportunity must be right. A window of opportunity must exist. (For example, the window of opportunity for the delivery of a wedding cake closes on the day of the wedding. If the wedding cake is delivered on the morning after the wedding, it is worthless.)

Table 2.1: Advantages and disadvantages of buying an existing business

Advantages	Disadvantages
Customers will be familiar with the business location.	The business location may be undesirable or threatened with be undesirable.
There will be an established customer base.	The image of the business will be difficult to change.
Experienced employees will come with the business.	Employees are inherited rather than chosen.
Planning can be based on known historical data.	There may be difficulties in changing the way the business is rur
Supplier relationships will already be in place.	There may be liabilities for past business contracts.
Inventory and equipment will be in place.	The inventory and equipment may be obsolete.
Financing may be available from the owner.	Financing costs could drain the cash flow and threaten the surviv business.

Thus, good opportunities are those that satisfy a market need, are well timed and reward the entrepreneur.

However, generating a good idea and starting a new venture from scratch is not the only way to enter the business world. Buying an existing business or procuring a franchise can reduce many of the uncertainties faced when starting a business.

2.7.3.3 Buying an existing business

There are several advantages to buying an existing business when compared with other strategies for entering the business world. Since customers are used to doing business with the company at its present address, they are likely to continue doing so once it has been taken over by a new owner. If the business has been making money, the new owner will break even sooner than if he or she started the business from scratch. Planning for an ongoing business can be based on previous financial records, instead of on projections as with a start-up business. Inventory, equipment and suppliers are already in place, and the business is managed by employees who know from experience how to keep the business going. In addition, it may be possible to obtain financing from the previous owner.

If the timing of the deal occurs when the entrepreneur is ready to buy a business and the owner needs to sell for a legitimate reason, this may be the best way of entering the business world. There may be disadvantages, however, in buying an existing business, as Table 2.1 shows. In addition, one cannot simply buy an existing business in the hope that it is or will be an ongoing success. The business remains an opportunity for which a feasibility analysis will be necessary.

2.7.3.4 Franchising

Another way of entering the business world is through the acquisition of a **franchise**. The franchise concept gives an entrepreneur the opportunity of starting a business that has been proven in the marketplace. The entrepreneur then becomes a **franchisee**. The **franchisor** gives the franchisee the right to operate a business, using the franchise company's name, products and systems. In return, the franchisee pays the franchise company for this right on an ongoing basis.

However, while the franchisor is an entrepreneur, it is not correct to view the franchisee as an entrepreneur who possibly initiates innovative ideas in the franchise system. Franchisees do not have the freedom to experiment, operate and market their businesses based on their own vision of how things should be done. Instead, they must usually adhere strictly to the plans of the franchisor. However, a recent study proved that franchisees do show an entrepreneurial orientation in certain situations, such as multiple-outlet franchisees.[23] Franchisors in many sectors have recognised the benefit of multiple-unit franchisees[24] and this is seen as an entrepreneurial continuation of the franchise trend.

Franchisors usually fall in the medium-sized to large business category, as the more successful franchisors usually manage large numbers of franchises as part of their business, apart from the overall management of the franchise group.

Franchising is an ideal model for the business support services industry. According to the Franchise Association of South Africa (FASA), South Africa has 625 franchised systems operating about 39 000 outlets and 17 franchise business sectors. It contributes around 12,5 per cent to the GDP of South Africa.[25]

Australia, on the other hand, has approximately 1 025 business format franchisors and nearly 70 000 units operating, and the UK has 809 franchise structures and 383 000 people employed by franchising.[26]

In South Africa, most reputable franchises are registered with the Franchise Association of South Africa. The purpose of this organisation is to ensure that franchising in South Africa is a quality concept that can enable entrepreneurs to start new businesses. FASA is an excellent source of information on franchises.

2.7.3.5 Corporate entrepreneurship

Corporate entrepreneurship (also known as intrapreneurship) is entrepreneurship in an existing business. It happens when a person or team develops a new corporate business within a business through identifying a new opportunity or business idea. Corporate entrepreneurship is a method by which a corporation or large business introduces new and diversified products or services to an existing business. This is done through internal processes and by using the corporation's resources. Corporate entrepreneurship creates opportunities for a corporation to diversify, as well as for the creation of new industries. In addition, corporate entrepreneurship enables investment and profits through the establishment of new businesses within a business.

Corporate entrepreneurs are also valuable wealth creators in an economy. The advantage of new businesses established in this manner is that sufficient funding or seed capital is usually available for the capital-intensive establishment phase and the growth phase that follows.

The case study on page 66 illustrates two women entrepreneurs who have become symbols of change in their profession. They started their own civil engineering business. This was breaking the norms and defying the odds as they showed courage and determination to enter a male-dominated market. They learnt the harsh realities of running their own business as opposed to working in a corporate environment. Some of the lessons they have learnt include the value of a support structure, financial management skills, the art of perseverance, hard work and resolute determination. What is important for them is that they are creating jobs and making a difference in people's lives.

2.7.4 The feasibility of the idea or opportunity

Many small businesses result from an idea that has been converted into a useful application. Ideas have little value until they are converted into new products, services or processes. However, as was discussed in previous sections, not all ideas can be converted into feasible ventures. An idea must therefore be subjected to a feasibility test to prove that it has value. Aspiring entrepreneurs often find that the idea has already been developed or that competitors already exist. The same applies to opportunities that entrepreneurs may recognise. The entrepreneur should therefore also do a feasibility analysis of any apparent opportunity.

CASE STUDY: Two black South African women make waves as entrepreneurial engineers

While more than 50 per cent of women have left the engineering sector since 2015, these two women are determined to continue breaking the norms and defying the odds. Earlier this year, it was reported that many women engineers have left the industry because of the gender bias they experienced. But this is not the case for Lusanda Tyebileyo, 32, and Lerato Kotane, 30, who symbolise change in their profession. In South Africa, only 11 per cent of civil engineers are women, and few of these are black women. Tyebileyo and Kotane possess remarkable fortitude in their determination to succeed. The two women are the founders and directors of the Tisang Group, a 100 per cent black-women owned general building and civil construction company.

Engineering is a tough profession for any one. 'In my first year of engineering, a lecturer told the class: "Only one in two of you will graduate",' recalls Tyebileyo. Growing up in a male-dominated household with four brothers and her father, Tyebileyo learned early on to stand on her own two feet. 'My thinking has always been "I can do what boys can do" so the fact that engineering is a male-dominated profession didn't daunt me. My father encouraged me and my mom knew I was as stubborn as my father!' Tyebileyo then pursued her dream at Wits University. It was here that she met her entrepreneurial partner, Kotane. Kotane admits that she had considered a career in fashion design or architecture before settling on engineering. 'The fact that I had such good grades in maths and science led my parents to question my initial career choice,' says Kotane. 'To this day I am grateful for their guidance. I would not trade these past 10 years for anything; nothing excites me more than contributing towards transformation and being counted among the female engineers who can make an impact,' says Kotane. Fresh from university, Kotane had to fight to be taken seriously as a black woman in a white male-dominated industry. She had to work harder than her male counterparts to prove herself, and she had to report to less qualified or junior male counterparts.

Starting their business was tough. 'We were very naïve,' says Tyebileyo. 'We understood engineering and the construction sector quite well, but working in corporate is very different from running your own business.' Their efforts to win government contracts were fruitless. 'There's a stigma that if you are a woman and black then the road is clear and that you will get to your destination quicker,' says Tyebileyo. 'But it doesn't work that way.' 'You still need to prove yourself,' adds Kotane.

Kotane emphasises the importance of entrepreneurs having a support structure. 'We have also aligned ourselves with seasoned female mentors and entrepreneurs, who have experience in the industry,' she says. Perseverance is also key and pays off. After a lot of hard work and resolute determination in the face of rejection, the Tisang Group landed several projects in the power and renewable energy field. Despite their growing success, the entrepreneurs admit that they need to continue to improve their financial management. They are not alone in this – poor financial management is a key factor behind the high failure rate among South Africa's small and medium enterprises (SMEs).

It is for this reason that Kotane and Tyebikyo approached the South African Institute of Chartered Accountants (SAICA), which is addressing this lack of financial management capability by helping SMEs with crucial back-office accounting support and financial literacy training. The programme focuses on two challenges in South Africa: providing relevant work

experience and skills to unemployed graduates, and addressing the high failure rate of SMEs through providing internal controls, risk management and reporting. The project has assisted over 120 SMEs since 2012.

To be eligible to enter the SAICA J.P. Morgan flagship programme, SMEs have to go through a rigorous assessment process and pitch session prior to their participation to the programme being approved. So, what sterling qualities did the selection panel see in the Tisang Group? 'We were focusing on the level of entrepreneurial flair that supports the business,' says Mandisi Nombembe, project manager for SAICA Nation Building. 'The company directors had an articulate strategy and a well-structured business plan to back it up.' 'As a 100 per cent black-owned civil engineering business, we applaud the courage of the two female directors in entering a male dominated market,' adds Nombembe. Kotane is also grateful for their guidance: 'I would not trade these past 10 years for anything. Nothing excites me more than contributing towards transformation and being counted among the female engineers who can make an impact,' she says.

These two women are no doubt great role models. They have acquired significant experience in their individual career paths and are working on high-risk projects such as the Kusile Power Station, the fourth largest coal-fired power station in the world and contributing to new power generation in South Africa. More importantly, they are creating jobs and making a difference in people's lives.

Source: W24. 22 August 2017. Here's how two black South African women are making waves as fab entrepreneurial engineers. Available at https://www.w24.co.za/Work/Jobs/heres-how-two-black-south-african-women-are-making-waves-as-fab-entrepreneurial-engineers-20170822. [Accessed on 12 December 2018]. Reprinted by permission of SAICA.

Even buying an existing business or recognising a franchise opportunity does not necessarily mean that the new or existing venture will be an instant success. No matter how promising the idea or opportunity may appear, the entrepreneur should determine whether it is feasible as soon as possible. Doing a feasibility analysis in good time may prevent the entrepreneur from losing valuable resources on an idea or opportunity that in fact offers little hope of success.

A feasibility study is the collection of data that helps forecast whether an idea, opportunity or venture will survive. The feasibility study gives the entrepreneur an information profile that should enable him or her to take a definite decision on whether or not to go ahead with the venture. A feasibility study is not the same as a business plan. It precedes the business plan and consists mainly of gathering data to enable the entrepreneur to take a decision on whether to go ahead with the idea, opportunity or new venture. Once the feasibility of an idea has been assessed, the entrepreneur can commit to implementing the idea or abandon the idea altogether, depending on the outcome.

When an idea appears feasible, the entrepreneur can proceed to determine how to make the idea work. In other words, the entrepreneur must now decide how to translate the idea into reality. This stage entails the drawing up of a **business plan**. Because of its significance to the entrepreneurial process, the business plan will be discussed more fully in Chapter 3.

2.8 Entrepreneurship and the Fourth Industrial Revolution

The focus in today's economy is technology and the automation of processes. The Fourth Industrial Revolution, which includes Artificial Intelligence (AI), plays a leading role in these processes.

Industrial Revolution

The First Industrial Revolution began in the 18th century, with the invention of the steam engine. The power behind the Second Industrial Revolution was electricity, which enabled mass production. In the Third Industrial Revolution electronics and information technology were used to automate production. The Fourth Industrial Revolution is on our doorstep. The main differences between previous revolutions and the Fourth Industrial Revolution is the increased pace of change – breakthroughs are happening at a rate unprecedented in history and bring with them a new scale of disruption. Today, every industry is transforming at an accelerating speed.[27] The Fourth Industrial Revolution is characterised by key technologies such as genetics, Artificial Intelligence, Cloud computing, nanotechnology, biotechnology, and 3-D printing.[28]

Entrepreneurship has a pivotal and highly important role to play in the economic dispensation of the emerging Fourth Industrial Revolution (Industry 4.0), which is characterised by increasing digitisation and interconnection of products, value chains and business models. Competitiveness no longer depends solely on optimisation of own resources, but on total inter-organisational value chain innovation and supportive partner technologies, products, services and systems. With the aid of partners, organisations are co-creating innovative inter-organisational value and supply chains that operate in a local, regional and international collaborative business ecosystem.[29] The Fourth Industrial Revolution impacts on both individuals and society. It has the potential to raise income levels and improve the quality of life for all people.

The Fourth Industrial Revolution presents a tremendous opportunity for businesses in Africa to raise their global competitiveness and play a more important, decisive role in shaping the future of this continent. Africa cannot wish the Fourth Industrial Revolution away. There are investments Africa should make, for example to create a pipeline of future talent that can embrace the age of emerging technology. African schools, further education and vocational training should focus on science, technology, engineering and mathematics (STEM). It is of the utmost importance for Africa and its peoples to be fully prepared to take advantage of the powerful wave of emerging technology that is shifting the nature of work globally. In the face of the Fourth Industrial Revolution, Africans should embrace innovation hubs throughout the continent. Our civil societies, academic institutions and governments are already taking the lead in this field. They recognise that technological innovators can thrive in an enabling ecosystem.

The Fourth Industrial Revolution however also presents challenges, one of which is that Africa's leading industries are labour-intensive; there is a high risk that automation will leave hundreds of thousands of people unemployed. In South Africa alone, almost 500 000 jobs are created through mining, an industry highly prone to the introduction of automation.[30] This calls for an entrepreneurial mindset that is creative and innovative enough to reduce unemployment rates.

Artificial Intelligence

Artificial Intelligence (AI) is a field concerned with studying the nature of intelligence by using computers as a new and revolutionary tool to produce intelligent behaviour.[31] This field began in the late 1950s. Some authors explain AI as machine intelligence while others regard AI as a concept broader than machine learning. AI and machine learning are used behind the scenes to impact our everyday lives, informing business decisions and optimising operations for some of the world's leading companies.

In the near future, AI will have an increasing impact on our lives. It is already here, in a variety of ways:

- **Autonomous vehicles:** Autonomous vehicles are self-driving vehicles or trucks in which human drivers do not control the operation of the vehicle. As 'driverless' cars, they combine sensors and software to control, navigate and drive the vehicle.
- **Social Media:** Artificial intelligence already plays a significant role in this industry.
  - »Twitter uses AI behind the scenes to enhance their product. They process vast amounts of data through deep neural networks in order to learn what users' preferences are.
  - »Facebook draws value from a larger portion of its unstructured datasets (created by almost 2 billion people updating their statuses 293 000 times per minute). Most of its deep learning technology is built on the Torch platform that focuses on deep learning technologies and neural networks.
  - »Instagram uses big data and AI to target advertising, and fight cyberbullying and delete offensive comments. As the amount of content grows on the platform, AI is critical in giving users information which will enhance the user experience, such as the elimination of spam.

The list of AI trends in use today are inexhaustible. These trends continue to replace people with machines and technology. A good entrepreneur should work with these current trends rather than fight them. AI is here to stay and will continue to impact both the small business market and big industries. Who would ever have thought you could ask Siri questions and get accurate answers? Robotic workforce and AI medical diagnostics are in use today.

CASE STUDY: #WAKANDAFOREVER: What black panther means for the future of African innovation, technology and perspectives

A case study that showcases and epitomises Artificial Intelligence, Africanised thinking and highly technological process is displayed in the film industry, in the latest movie, Wakanda - Black Panther. Black Panther is a Hollywood film that reawakens African consciousness and directly reminds us of what the power of technology can achieve. Black Panther has been a cinematic success by all accounts. A record-breaking box office has already topped $US1 billion worldwide and is on track to be the top-grossing film in history. It is hailed by critics and audiences alike. Enough has probably been said in the last months of 2018 about Black Panther. It's a film set in an incredible African world of science and technology led by an impressive combination of black actors, all put together by a young black director. Yes, it's a Hollywood film. Yes, it's a Marvel super-hero film. Yes, it's a world-class action movie. Perhaps not a cultural revolution. But Black Panther is a game changer.

Above all else, Black Panther is a reawakening of African consciousness that directly reminds us what the power of representation together with the power of technology can achieve.

TECHNOLOGICAL EXCELLENCE IS OURS TOO

The setting of Black Panther, the land of Wakanda, is full of high-rise cities and technological and medical marvels. From infrastructure to transportation to communications to weaponry, the film represents an incredible technological revolution. However, the reality of an African country of that nature is probably closer than many think and realise. The world's biggest tech companies, Google, Facebook and Amazon have all expanded their offices and operations across the continent. The last ten years have spawned the arrival of over 300 active and growing tech hubs and incubators. Before filmmakers, Ryan Coogler and Joe Robert Cole imagined Black Panther, Ghana's Kwame Nkrumah began laying the foundation of scientific equity with his programmes. These were rooted in using science and technology

to build a continent both modern and distinctively Africa. The foundation for what Wakanda has visually realised.

A world dependent upon African science and technology is actually at our fingertips. Black Panther introduced so much technology on screen that surpassed the rest of the Marvel universe of Iron Man and hammer wielding gods; next level nanotech, kinetic energy storing suits, force-field shields, remote driving and piloting devices, handheld holographic displays, automated medical treatment, magnetic wave transportation, active cloaking and more. The reality is we have innovation leading the world's next wave:

- Wits University students in Johannesburg developed an affordable brain-controlled prosthetic hand using 3D printing.
- A group of students at Wits, Brainternet, managed to connect a human brain to the Internet for the first time.
- LifeQ is leading the charge in non-invasive body monitoring devices.
- ArcAqua is eliminating food wastage by using ozone technology.
- South Africa's first self-driving car trials started in 2018.
- Luno is arguably the most popular Bitcoin wallet in the world, and the easiest to use.
- Fintech startup, Zoona, is leading the charge in helping bank the unbanked with over $1 billion in transactions.
- A blockchain-based development management, code review and version control system, EngineOne, funded by Silicon Valley VC startups across Nigeria, Kenya, Rwanda and Ghana, is leading the next wave of fintech, edutech and legaltech companies.

BLACK GIRLS RULE STEM

I'm not the first to say that Black Panther has been an important landmark. But perhaps the most impactful and important part of Black Panther is that science and black women and girls take a front seat! Shuri, King T'Challa's teenage sister, played by Letitia Wright, is not only the breakout star of the star-studded cast but perhaps the most influential character of the film.

The mastermind and hero behind Wakanda's incredible innovations, putting all other Marvel tech experts to shame, is a girl! A black girl! An incredibly confident and sometimes cheeky one too! The fact that such a character leads the charge of STEM (Science, Technology, Engineering, and Mathematics) is something unlike we've seen before.

Shuri impacts us from her very first scene and through the movie she displays an innate ability to mould the world's most valuable substance, vibranium, into a catalyst for scientific innovation. She's the genius behind arguably the most highly-advanced society we've seen on screen. Her character never tires, consistently creating and recreating, fine tuning the source of the Black Panther's power, protection and arsenal of tools. Shuri's inventions are also focused on medical innovation, transportation, communications and improving the Wakandan way of life. Representation matters. Broadening the characters we see on screen, especially scientists, is profoundly important.

Wakanda is a world where black women are vital and integral to every part of life. We needed characters like Shuri to show young girls what is possible. In addition to amazing organisations like Black Girls Code and Digital Undivided, they now have an especially strong role model who shows how cool STEM really is. 'It is thrilling to see how inspired young audiences were by the spectacular technology in the film, so it's fitting that we show our appreciation by helping advance STEM programs for youth, especially in underserved areas of the country, to give them the knowledge and tools to build the future they want', said Bob Iger, Chairman and Chief Executive Officer of the Walt Disney Company. Hubs dedicated to STEM supported by the UN, Google, Facebook and IBM are also rising across the continent in South Africa, Ethiopia, Ghana, Kenya, Nigeria and Uganda. Broadening the diversity we see can only be positive, creating a notion of 'if they can do it, so can I!'

We are Vibranium

The secret to the Black Panther and Wakanda's strength, power and technological capabilities is the highly coveted *vibranium mineral*. Vibranium is the strongest, most resilient and most sought-after substance on the Marvel earth. In the film it's used to make weapons, vehicles, the energy absorbing/bulletproof Black Panther suit and other exponential technology. Even Captain America relies on a shield made from vibranium. It's Wakanda's secret sauce as they literally veil their land as a poor African country.

My interpretation of this substance is perhaps the most important theme of the film:

•Vibranium represents us.

•Vibranium is we, African people.

•Black Panther represents what happens when we harness the vibranium within ourselves.

An untapped, under-utilised, secret resource.

What if we saw everything in ourselves as having the potential to create limitless innovations and change? An entire society? Wakanda leapfrogs the entire world just by harnessing its own natural resources. What if we harnessed our own?

What if we used our brightest, most creative, hard-working individuals for the uplifting of our own selves?

Instead of replicating Silicon Valley. Instead of copy and pasting innovation from the rest of the world. What if we took all our collective unmined excellence to build us? Black Panther normalised that potential.

We have to be opportunity seekers

Think of this:

•By 2030, the continent will have the second largest workforce in the world.

•Africa has the world's youngest population.

•We house nine of the top 20 fastest growing economies.

•Female entrepreneurship is highest in the world in sub-Saharan Africa at 25,9 per cent.

These insights present an opportunity for exponential growth and potential. However, the opportunity of a lifetime only exists during the lifetime of the opportunity. The global perception of our continent is that you shouldn't expect growth or excellence from us. That we can't impact the world with technology or development. Black Panther has represented an amazing achievement and shift. A world-class critically acclaimed uniquely African story on a scale unseen before. Wakanda started showing us the possibilities of our continent. It's now up to us to actualise that story into our daily lives. Reframing our conversations, our decisions, our motivations for a new continent for our children. Rooted in record-breaking excellence. Afro-futuristic utopia to reality. Perhaps black excellence is an overused term, but Black Panther's reimagining of Africa should push us to define and live out a new African state of being. Technological and scientific super power. A better future beckons, and it's closer than you think.

Until then… #WakandaForever

Source: Mutuma, M. #WakandaForever: What Black Panther means for the future of African innovation, technology and perspectives. Available at http://www.mushambimutuma.co/wakandaforev-er-what-black-panther-means-for-the-future-of-african-innovation-technology-and-perspectives/. [Accessed 27 October 2018]. Reprinted by permission of Mushambi Mutuma, CEO of Altivex.

2.9 The small business

The concept of entrepreneurship is strongly associated with establishing or owning a small business, so attention is drawn to the distinction between entrepreneurship and small business by defining a small business and explaining its role in the economy.

2.9.1 Defining a small business

It is difficult to formulate a universal definition of a small business because the economies of countries differ, and people adopt particular standards for specific purposes. South African towns typically have a variety of small businesses, such as the local hairdressing salon, the greengrocer, the video shop and the hardware store.

An example of a small business would be a restaurant started by a woman who was previously an employee at a different restaurant, where she learnt about the restaurant business. She then started her own restaurant after identifying a need for a specific type of restaurant – for example, one specialising in organic food. This owner is now satisfied with the success of her restaurant and the income she earns from it, and has no plans or inclination to expand or open other restaurants.

What may be considered a small business is also relative to one's frame of reference. A local supermarket regarded by some people as big may actually be small in comparison with a business such as Pick n Pay. Likewise, medium and even large businesses in South Africa may be small in comparison with their overseas counterparts. In most countries, it is therefore accepted practice to make use of quantitative criteria when attempting to define a small business enterprise. Examples of quantitative criteria in defining a small business are:

- the number of employees;
- the sales volume;
- the value of the assets; and
- the market share.

In the National Small Business Amendment Act (No. 29 of 2004), micro-businesses in the eleven different sectors are defined as businesses with five or fewer employees and a turnover of up to R200 000. Very small businesses employ up to 10 or 20 employees, depending on the sector. Small businesses employ up to 50 employees, and have a total annual turnover ranging between R3 million and R32 million, depending on the sector in which the business is classified, and with a total gross asset value ranging between R1 million and R6 million, again depending on the sector.[32] Medium-sized businesses usually employ up to 100 or 200 people (depending on the sector), and the maximum turnover varies from R5 million in the agricultural sector to R51 million in the manufacturing sector, and to R64 million in the wholesale trade, commercial agents and allied services sector.[33]

A comprehensive definition of a small and medium-sized enterprise (SME) and a small, micro and medium-sized enterprise (SMME) in South Africa is therefore any enterprise with one or more of the following characteristics:

- fewer than 200 employees;
- an annual turnover of less than R64 million;
- capital assets of less than R23 million; and
- direct managerial involvement by owners.

Oasis Group Holdings, the subject of the case study on page 49, is an example of an entrepreneurial business that began as a small business with limited funds but that, through the entrepreneurial flair of its owner, developed and grew to be a medium-sized to large business.

2.9.2 The role of small businesses in the economy

In developed economies, the entrepreneur is recognised as a key factor in the process of economic development. Entrepreneurs innovate, take risks and employ people. They

create markets and serve consumers by combining materials, processes and products in new ways. They initiate change, create wealth and develop new enterprises. More specifically, the strategic role of small business in any economy revolves around the production of products and services, innovation, the aiding of big business and job creation.

2.9.2.1 The production of products and services

Small businesses combine the resources of society efficiently to produce products and services for the society in which they operate. Small businesses are less inhibited by large bureaucratic decision-making structures, and are more flexible and productive than many large firms. In advanced economies, they not only employ the majority of the workforce, but also produce most of the products and services.

2.9.2.2 Innovation

Small businesses have been responsible for most of the innovation worldwide. Statistics show that many scientific breakthroughs in the United States originated with small organisations and not in the laboratories of large businesses. The following are some examples of the new products created, developed or invented by entrepreneurs:

- photocopiers;
- jet engines;
- Insulin;
- helicopters;
- vacuum tubes;
- colour film;
- Penicillin;
- ballpoint pens;
- zips;
- personal computers; and
- Velcro.

More recently, the following technology-related products and services have been created, developed or invented by entrepreneurs:

- cellphones;
- The Internet;
- search engines such as Google;
- microchips;
- MP3 players such as the iPod;
- Internet-safety software;
- Mxit; and
- drag-and-draw digital paint sets.

2.9.2.3 The aiding of big business

Any country needs large enterprises to be able to function competitively in local and, especially, in international markets. The Japanese mega-corporations, for example, compete internationally as world players and have conquered markets that earn them billions in foreign currency for domestic development. In the process, they provide millions of local suppliers with orders. It is the efficiency of the local suppliers, however, that enables the big corporations to compete internationally. Small businesses not only act as suppliers to large businesses, but also distribute their products.

2.9.2.4 Job creation

As was previously stated, small businesses provide many of the new job opportunities needed by a growing population. In fact, they create jobs, whereas large corporations are shedding jobs.

The small business is often entrepreneurially driven. It is this entrepreneurial spirit that is in particular encountered in the smaller enterprise that is the catalyst for economic development and job creation. Small businesses tend to stimulate competition and thereby improve productivity.

2.10Summary

This chapter addressed the concept of entrepreneurship and the idea that the entrepreneur is the driving force behind the business organisation. The role of entrepreneurs in the economy was examined, as were the reasons for people becoming entrepreneurs. Following this, the various aspects and phases of the entrepreneurial process were explored, including an assessment of the entrepreneur's unique abilities and skills, access to resources, the search for opportunities and the feasibility study.

Small business perspective

There is no universal definition of a small business. What is regarded as a small business in one country may not necessarily be the case in another country. There are however guidelines to describe what small and medium-sized enterprises (SMEs) are. These are quantitative and qualitative guidelines. Examples of quantitative guidelines are the number of employees in full-time service, number of business units or branches, total number of assets (excluding property) and annual turnover or income of the business. Qualitative guidelines include a simple organisational structure that is independent and privately owned and managed. The administrators and legislators of countries draw up their economic policies according to these guidelines in order to encourage economic growth.

Small- and medium-sized enterprises are important engines for the development of rural economies and communities in many countries of the world. Their contribution to the economy includes economic development, job creation and employment, the promotion of entrepreneurship and the stabilisation of communities. The percentage of enterprises to larger organisations in many developed and developing countries is more than 95 per cent.

KEY TERMS	
achievement motivation	industrial revolution
Artificial Intelligence	innovation
business	internal locus of control
business plan	job creation
calculated risks	life cycle
capital	life-cycle stages
characteristics	machine learning
corporate entrepreneurship	managing a business

creativity	marketing skills
employment	necessity entrepreneur
entrepreneur	operating resources
entrepreneurial process	opportunities
experience	opportunity entrepreneur
feasibility	outsourcing
financial resources	physical resources
franchise	small business owner
franchisee	social trends
franchisor	traits
human resources	

Questions for discussion

Reread the case study on page 49 and answer the following questions:

1. What do you regard as the three main reasons for the success of Oasis Group Holdings? Explain why you chose each reason.
2. Do you think Mr Ebrahim was an entrepreneur or an owner of a small business after he started the business? Give reasons for your answer.
3. How do Mr Ebrahim and his company contribute to the economy of South Africa?
4. Do you think Mr Ebrahim is a necessity entrepreneur or an opportunity entrepreneur? Give reasons for your answer.
5. Why was Mr Ebrahim's business idea a good opportunity? Discuss and give reasons for your answer.
6. The Fourth Industrial Revolution has both opportunities and challenges for businesses in Africa. Discuss how the challenges should be addressed.
7. Artificial Intelligence impacts our everyday lives and informs business decisions of some big companies. Discuss how small businesses can use Artificial Intelligence to their advantage.

Multiple-choice questions

1. Scientists have different views on whom or what an entrepreneur is. Which one of the following is the view of an economist?
   a. The entrepreneur is an exploiter.
   b. The entrepreneur is a small-business owner who lacks the potential to manage a large company.

c.The entrepreneur combines different resources in specific combinations to generate products and services at a profit.

d.The entrepreneur is a person with an achievement orientation and a propensity for creativity and risk-taking.

2.There is a need to combat South Africa's high unemployment rate of over 27 per cent. Which one of the following statements describes a significant reason for South Africa's high unemployment level?

a.No business opportunities

b.No skilled and competent labour force

c.Not enough people with business and entrepreneurial abilities

d.Not enough markets for products and services.

3.The entrepreneurial process is the creation of new value through the entrepreneur identifying new opportunities and using his or her leadership skills to build an organisation that fits the opportunity, and attracts and manages a configuration of resources with the focus on exploiting the opportunity. Which option shows the order in which the entrepreneurial process occurs?

a.The opportunity, the feasibility study, the business plan, abilities and skills, access to resources, managing the business.

b.Abilities and skills, access to resources, the opportunity, the feasibility study, the business plan, managing the business.

c.The business plan, abilities and skills, access to resources, the opportunity, the feasibility study, managing the business.

d.The feasibility study, the opportunity, abilities and skills, access to resources, managing the business, the business plan.

4.The Fourth Industrial Revolution can be distinguished in many ways. Which of the following factors does not characterise the Fourth Industrial Revolution?

a.Biotechnology

bInkjet printing

c.Cloud computing

d.Artificial Intelligence

5.There are many examples of Artificial Intelligence that impact on our lives. Which one of the following is not associated with AI?

a.Social media

b.Live theatre

c.Instagram

d.Autonomous vehicles

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CHAPTER 3

Establishing a business

Johan Strydom

The purpose of this chapter

This chapter focuses on the different forms of enterprise or legal ownership that are available to the entrepreneur and small business person. It covers the characteristics, advantages and disadvantages of the sole proprietorship, the partnership, the close corporation, the business trust, the company and co-operative societies. Each of these forms of business is discussed in order to enable students to compare them, and make informed decisions about the legal ownership issues of these businesses. Once the entrepreneur knows what the available options are, he or she will be able draw up a business plan for the new business. The basic steps in the development of a business plan are then explained. The location factors that play a role when starting the business are also discussed here.

Learning outcomes

On completion of this chapter you should be able to:

- •understand and discuss the key considerations that are applicable when a form of business has to be chosen
- •distinguish between the different forms of enterprise found in South Africa
- •explain the objectives, importance and need for a business plan
- •evaluate a business plan
- •give an overview of a business plan
- •identify the location factors and the impact of these on a business.

3.1Introduction

This chapter focuses on the different forms of enterprise that are available to the entrepreneur. It explains the factors that should be taken into account in selecting the appropriate form of enterprise for a particular business. The characteristics of the sole proprietorship, the partnership, the close corporation, the company, the business trust and the co-operative society are explained, and the relative advantages and disadvantages of each are highlighted.

The Companies Act (No. 71 of 2008) was assented to on 8 April 2009 and took effect on 1 May 2011. It repealed the Companies Act (No. 61 of 1973), except for Chapter XIV which deals with winding up of Companies. The Companies Amendment Act (No. 3 of 2011) was signed into law on 20 April 2011. The Companies Regulations, 2011 and forms under the Companies Act (No. 71 of 2008) were published on 26 April 2011. Some very important changes have resulted from the current South African corporate law reform, impacting on the various business forms under discussion. These changes could affect the choice of emerging entrepreneurs significantly regarding the selection of a business form.

An entrepreneur who is aware of the various business forms and their implications can make an informed decision about the structure of his or her business. Once the

entrepreneur understands what the available options are, he or she can draw up a business plan for the new business. The basic content of such a business plan and the different issues that should be evaluated are also discussed in this chapter. In addition, the location factors of a business are examined as these are paramount for the success of the business.

3.2The legal form of ownership[1]

3.2.1Introduction to the legal form of ownership

An entrepreneur can conduct business through various forms of enterprise. An enterprise is an organisational structure through which business is conducted. Several options are available to the entrepreneur. However, there are many issues that should be considered when deciding on the form of ownership. These issues include the extent to which the entrepreneur wants to be liable for financial and legal risk; who will have a controlling interest in the business; and how the business will be financed.

It is clear that one of the first issues facing an entrepreneur about to enter into a business undertaking is the selection of the type of enterprise. This decision can have a tremendous impact on almost every aspect of the business. As a business changes over time, a different business form may become more fitting. Therefore, knowledge of the different enterprise forms is crucial in planning for the possible future growth, or transfer, of a business.

Many factors may influence the entrepreneur's decision regarding the best business. Therefore, knowledge of the various forms of business is imperative for the entrepreneur. Considerations include the size of the business, the nature of the proposed business activities, the participation style, the management structure, the financing needs, the accountability of participants, and tax and legal implications. The key to choosing the 'right' form of ownership lies in understanding the features of each enterprise and how it will influence an entrepreneur's specific business and personal circumstances. A characteristic of the business form that can be considered decisively beneficial for one business may be viewed as a distinct drawback in another business. Although, generally speaking, there is no best form of enterprise, there may well be one form best suited to each entrepreneur's specific circumstances.

The characteristics of each of the enterprise forms will be explained with reference to a number of key considerations: independence, liability, control, compliance, taxation and transferability.

3.2.2Considerations when choosing a form of enterprise

From a legal point of view, the most pertinent consideration in choosing a form of business is whether the enterprise will have **legal (or juristic) personality**. A legal or juristic person exists independently of its members. It is recognised as a legal subject alongside natural persons or individuals. It has its own rights, assets and obligations. Its existence is not affected by changes in its membership. This provides the business with continuity (also known as **perpetual existence**). Therefore, the business could potentially exist forever. The members are usually not liable for the debts or obligations of the juristic person. Members enjoy limited liability and they usually stand to lose only the capital they have contributed to the entity. Only in exceptional circumstances will participants be held personally liable for the debts of a business that offers the benefit of limited liability.

Limited liability means the protection afforded by the juristic person to its members or owners in the event of it being sued. Claims are, for example, made against a company and the assets for payment of the company debts, and not against the personal estates of the company's shareholders or directors or against the estates of members of a close corporation.

However, despite the fact that limited liability is closely associated with separate legal personality, it is not an automatic consequence of being a juristic person. An exception to the rule that juristic personality provides limited liability is the personal liability company. In this special type of company that is recognised by the Companies Act (No. 71 of 2008), directors and previous directors of the company are liable for payment of all contractual debts incurred during their terms of appointment as directors. Conversely, despite the fact that trusts (including business trusts) are generally not considered to be juristic persons as trust assets are held in the trustee's personal estate, trusts do enjoy limited liability in the sense that only the assets in the trust estate according to the trust deed are used to settle trust debts. Although a partnership is recognised as a 'person' who is eligible for registration as a vendor for purposes of the Value Added Tax Act (No. 89 of 1991), they are not generally recognised as juristic persons. Nevertheless, in the course of a partnership's existence, partners can only be held jointly liable for the debts of the business. In addition, when judgment is taken against a partnership, sales in execution of judgment are usually affected against partnership assets before the partners' personal estates. If a partnership is sequestrated, the personal estates of partners are also dealt with separately from the partnership estate in payment of the debts of the partnership for so far as this is possible. In other words, a (temporary) measure of restricted personal liability is provided for in the course of the existence of a partnership despite the absence of juristic personality.

Companies, close corporations and co-operative societies are juristic persons, while sole proprietorships and partnerships are not. In trusts, the position is more complicated. Generally, trusts are not viewed as juristic persons. However, in terms of certain legislation, such as the Income Tax Act (No. 58 of 1962), the Deeds Registries Act (No. 47 of 1937), the Transfer Duty Act (No. 40 of 1949), the Insolvency Act (No. 24 of 1936) and the Companies Act (No.71 of 2008), trusts are considered to be juristic persons.

The extent of the liability of the business owner is a very important consideration. Ideally, an entrepreneur would like to insulate his or her personal assets from the business creditors so that he or she will not lose everything should the business be unsuccessful. The members or shareholders of companies, members of close corporations, and participants in co-operative societies are usually not liable for the debts of the enterprise. In contrast, sole proprietors and partners are liable in their personal capacities for the debts of the business. The trustee or beneficiary of a business trust is, in principle, not liable for the payments of trust debts. According to South African law, the trustee is considered to have two separate estates: one being his or her personal estate, and one for the trust assets. Trust debts are usually paid out of the separate trust estate only.

The degree of control or management authority the entrepreneur will be able to exercise over the activities of the business is another factor to consider. A broad range of options exists in this regard. A sole proprietor enjoys total management autonomy with respect to the business he or she owns. Companies are, however, characterised by a formal division between ownership and control. The participative management

structures of partnerships, co-operative societies and close corporations fall in between these two. Although a business trust is administered or managed by the trustee, the trust deed can apportion control between the trustee, the establisher of the business trust (the founder) and the trust beneficiaries.

Also of relevance is the potential for capital acquisition. Some businesses are extremely capital intensive and this factor may be decisive. In other businesses, capital may be of lesser importance owing to the business activities involved. A public company is ideally suited to raise large sums of capital. In other enterprise forms, like partnerships, close corporations and co-operative societies, the capital is provided by a limited number of persons and, therefore, their own financial positions are important. Factors including the number of participants, their exposure to risk and their say in the management play a role in financing decisions.

Compliance with legal formalities and regulations can impose a considerable administrative and financial burden on an enterprise. The requirements for, and the cost of, the establishment, management and dissolution of each form of enterprise differ. Irrespective of the particular enterprise form adopted, a business can be subject to a multitude of other legal and regulatory requirements that often depend on size-related factors such as turnover and number of employees. So, for example, employers who employ more than 50 employees, or have a turnover exceeding the amount stipulated by the Minister of Labour (currently R5 million), would have to comply (in addition to all other applicable legislation) with the obligations imposed by the Employment Equity Act (No. 55 of 1998), whereas other employers would be exempt. The Companies Regulations, 2011 provide that companies and close corporations with a turnover exceeding the amount stipulated by the Minister from time to time (currently R5 million) must audit their financial statements unless they are specifically exempted from doing so. Whether or not a company or a close corporation will be obliged to have its accounting records audited further depends on its public interest score. Companies and close corporations with a public interest score exceeding 350, or of at least 100 and that have their financial statements internally compiled, are obliged to audit their statements. Close corporations must audit their financial statements in the same circumstances as in private companies. All companies and close corporations may also subject themselves to an audit voluntarily.

Taxation is also an important consideration. All forms of business enterprises must pay taxes. The rates for income tax, capital-gains tax and transfer duty vary depending on the kind of taxpayer. The amount of tax to be paid depends on whether the business is owner-operated (that is, the owner is self-employed as is the case for sole proprietors and partnerships) or whether the business is a registered entity that has its own separate juristic personality (that is, companies and close corporations). Value-added tax (VAT), which is levied at a standard rate of 15 per cent, is applied irrespective of the enterprise form.

In terms of this tax regime a smaller business pays a fixed amount annually, irrespective of whether it had made a profit or suffered a loss in that particular financial year. The aim of having a different tax that applies to smaller enterprises is to minimise the cost and the administrative burden associated with smaller enterprises. A simplified method of paying tax, turnover tax, is available upon application, for use by small or micro-businesses, whether they operate as sole proprietors, partnerships, close corporations, companies or co-operatives. In order to qualify, the annual turnover of the business must not exceed R1 million per annum. This tax is payable instead of corporate income tax, capital gains and dividends tax. If the business chooses to do so, it may

remain on the VAT system. It is also possible to register a small business as a Small Business Corporation (SBC), which also attracts a lower rate of tax if the annual turnover of the business is less than or equal to R20 million. The rates of turnover tax for SBC tax rates ending on any date between 1 April 2018 and 31 March 2019 range between zero tax for an annual turnover below R78 750 up to tax of R58 930 on turnover exceeding R550 001, plus 28 per cent of any amount above R550 000.

Companies that do not qualify to pay the lower turnover tax rate all pay income tax (corporate tax) at the rate of 28 per cent, except for personal service provider companies and foreign resident companies earning income in the Republic, who are currently taxed at a rate of 33 per cent. Specific types of companies also enjoy certain tax benefits. Companies involved in gold mining and life insurance are taxed at a different rate according to a formula. Depending on the type of fund, life insurance funds are taxed at a rate between 0 and 30 per cent. Charity organisations and other non-profit organisations that are registered as Public Benefit Organisations are exempted from paying corporate tax. However, a non-profit organisation or nonprofit company (NPC) does not automatically qualify for preferential tax treatment. Nonprofit organisations can apply to the Tax Exemption Unit of the South African Revenue Service for approval as a public benefit organisation (PBO). PBO's, for as long as they comply with the strict requirements in the Income Tax Act (No. 58 of 1962) to qualify as a PBO, are exempted from paying corporate tax. Certain donations that are made by taxpayers to businesses involved in public benefit activities are also made tax deductible.

Close corporations and co-operative societies are also liable to pay corporate tax at this flat rate. South African-based businesses must pay corporate tax on their worldwide income, whereas external companies based outside South Africa that operate business in the Republic must pay tax on income derived within South Africa only. The income tax rate for trusts, excluding special trusts, is currently set at 45 per cent. Special trusts, like individuals, are taxed on a sliding scale ranging from 18 to 45 per cent.

Instead of the secondary tax on companies (STC), which used to be payable at a rate of ten per cent on the net dividends distributed to members, a withholding tax on dividends (dividend tax) is currently payable at a rate of 15 per cent on the gross amount of all dividends.

South African branches of foreign-resident companies are exempted from paying STC and dividends tax. Individuals are taxed on a sliding scale, with the maximum marginal rate set at 45 per cent. Business trusts are taxed at a flat rate of 45 per cent on the income retained in the trust.

Capital gains tax is charged on the net capital gain after certain permissible deductions. Certain exclusions apply for individual taxpayers, including permissible deductions in respect of gains or losses resulting from the sale of a primary residence, retirement benefits and payments for longterm insurance. In addition, an annual exclusion of R40 000 on the capital gain or loss is afforded to individual taxpayers, and also to special trusts, after which the net capital gain of the individual is taxed at 18 per cent. The tax rate for companies is 22,4 per cent and for business trusts it is 36 per cent of the net capital gain. Transfer duty is levied on a sliding scale based on the value of fixed property acquired by companies, close corporations and trusts. Companies and natural persons pay transfer duty at the same rate on a sliding scale. No transfer duty is payable in respect of property up to a value of R900 000, thereafter three per cent of the value of property of R900 001 and above. On property above R1,25 million in value, R10 500 plus 6 per cent for the amount exceeding R1,25 million is payable and if the

value of property exceeds R1,75 million, R40 500 plus 8 per cent of the value exceeding R1,75 million is levied. The rate of transfer duty payable on property with a value of greater than R2,25 million is R80 500 plus 11 per cent of the value exceeding R2,25 million. Transfer duty of R933 000 is payable along with 13 per cent for the amount exceeding R10 million for property valued above R10 million.

Notably, updated information regarding taxation of different business forms is made available regularly on the website of the South African Revenue Service: www.sars.gov.za.

Many factors will influence the total income tax burden of an enterprise. For this reason, no single enterprise form can be said to be the most advantageous from a tax perspective. The total income tax will depend on the amount of the taxable income (or loss) generated in the business (whether or not the enterprise is a separate taxpayer), the tax status and taxable income of the business owners, and the extent of distributions made to them.

It is sometimes said that double taxation arises with respect to companies and close corporations. Although it is true that income that has already been taxed in the hands of the company or close corporation is taxed again when it is distributed to members as dividends or payments, the effect is offset by the specific tax rates imposed on income and distributions respectively. The income of a sole proprietorship and a partnership is taxed in the hands of the sole proprietor or partners.

The income retained in a business trust is taxed in the hands of the trustee as representative taxpayer, while the beneficiaries are taxed on the income distributed to them during the tax year. Securities transfer tax for transfer of shares in companies or member's interest in close corporations is currently 0,25 per cent.

The ease with which the business or the entrepreneur can be transferred should also be considered when the most appropriate enterprise form is being selected. There may be many reasons why an entrepreneur may wish to, or have to, transfer his or her business or parts of it. Shares in public companies, especially if they are listed on an exchange, are very easily transferable and the most liquid form of investment in a business. In private companies, close corporations and co-operative societies the transfer of an interest is dependent on the approval of the remaining participants or members. Beneficiaries of a business trust may transfer their rights in accordance with the trust deed. A change in membership of a partnership has the effect of terminating the partnership.

The sections that follow will address the main characteristics of sole proprietorships, partnerships, close corporations, companies, business trusts and co-operatives in terms of these key considerations.

CASE STUDY: Location factors that influence most forms of small businesses

When establishing a small business there is a list of aspects to consider that could mean the difference between success and failure. This list includes the following:

- **Availability of raw materials**. If the small business is dependent on raw materials, it makes sense for the business to locate near to the source of this material. Small millers are usually found near to a farming area where maize is produced, for example. Even large SOEs such as Eskom are dependent on the continuous supply of coal from the coal mines near to the power stations.
- **Proximity to the target market**. In the convenience sector that includes fast food franchising, it is a necessary for the business be near to its customers. Linked to this proximity is developing customer loyalty so that customers keep coming back to buy from the business. Small businesses are far better suited to reaching small market segments that their larger competitors, which tend to overlook these market segments or

consider them to be unprofitable. Furthermore, using a customer-driven strategy is a must for small businesses that lack the financial and physical resources of their larger competitors. [2]

•**Availability of basic infrastructure**. The availability of services such as water, electricity and sanitation has been taken for granted, but there are indications that small businesses need to reconsider their dependence on third-level government institutions providing these services. More and more small business are aiming to get off the electricity grid and to invest in their own facilities, such as power generators, to alleviate the chronic supply problems that Eskom as a power supplier encounters.

•**Economic policy**. Economic policy and local government incentives may be a motivator for selecting a certain location. In some instances, local governments have developed trade zones where small businesses are provided with start-up assistance.

•**Method of distribution**. If the small business is a brick-and-mortar business, location will be one of its most important decisions. In today's world, technology and the increasing dominance of e-commerce sales are impacting on the location factor. An online retailer could be located in Cape Town but sell most of its products in Gauteng. It can therefore be said that the more small businesses make use of e-commerce, the less impact location may have in future. The proviso is that e-commerce must have a dependent distribution system to deliver products bought by customers. Some of the largest e-commerce suppliers struggle at times to provide consistent delivery performance during promotional periods such as Black Friday, which provides a spike in the demand for delivered products.

Critical thinking

Why is the concept of a legal or juristic personality so important in the selection of a business format?

3.2.3 The sole proprietorship

The **sole proprietorship** is a business that is owned and managed by one individual. This is a very popular type of business because it is very easy and inexpensive to set up.

A sole proprietorship is not a separate legal (juristic) person. It does not exist independently of the owner or proprietor. The lifespan of the business is linked to the lifespan or the legal capacity of the owner. If the owner dies, or becomes insolvent or otherwise legally incapable, this usually means the end of the business. If the business is discontinued, even temporarily following the death or incapacity of the sole proprietor, it may be difficult for the heir or transferee to resume the business.

There is no legal separation of the personal and business assets of the owner. Practically, it is preferable to keep separate books in respect of the business, but all the assets used in the business belong to the owner alone. Any profit of the business belongs to the owner in his or her personal capacity, even if it is kept in a separate business account or invested in business assets.

The owner does not enjoy any limitation of liability and therefore risks losing all of his or her personal possessions if the business is unable to meet its obligations. The owner is personally liable for all the debts and claims arising from the running of the business. Personal creditors can claim against business assets and vice versa.

The owner has direct control and authority over the activities of the business. The owner usually manages the business and is free to make decisions concerning the running of the business. The business is therefore able to adjust readily to changes. However, a sole proprietorship can, depending on the circumstances, make

exceptionally high demands on the management ability and personal freedom of the owner. The proprietor may delegate some or all management functions or decisions to employees or agents.

The capital-acquisition potential of the sole proprietorship depends on the owner's financial strength and creditability. The owner may already have sufficient assets or could rely on debt financing (loans).

A sole proprietor may encounter difficulty in obtaining sufficient funds, especially when the business reaches a stage of expansion. Financiers often limit their risk by insisting on some measure of control or supervision over the business operations.

Therefore, a sole proprietor may have to relinquish authority and freedom in exchange for funding. There are very few formalities and legal requirements for the establishment of a sole proprietorship. As a result, it is the least expensive enterprise form. In terms of the Consumer Protection Act (No. 68 of 2008), members of the public are required to register the name of a sole proprietorship with the Companies and Intellectual Property Commission. Apart from the prescriptions of the Business Names Act (No. 27 of 1960) that a chosen business name must not infringe on the rights of already existing businesses, there are no particular legal requirements for the establishment, management or dissolution of a sole proprietorship.

So far as tax liability is concerned, as mentioned above, the entire income of the business belongs to the owner even if the income is kept in the business. Accordingly, the income is taxable in the hands of the owner as an individual taxpayer. If the business suffers a loss, this can be set off against the owner's taxes.

From a legal perspective, transfer of ownership of a sole proprietorship is reasonably simple. The owner may at any time decide to sell the business, close down the business, or transfer the business or assets to someone else. However, it may be a problem to find a buyer. The business may be so closely associated with the persona of the proprietor that it may be difficult to place a value on the goodwill of the business. In some instances, the proprietor or executor may have to sell the business assets individually at a price that compares very unfavourably to the value of the business as a going concern. The advantages and disadvantages of a sole proprietorship are summarised in Table 3.1.

In the course of time, it has become evident that if two or more sole owners join forces, they are able to bring about a stronger unit because their combined financial and other resources are then at their disposal. This has led to the development of the partnership as another form of business available to the entrepreneur. The partnership is possibly one of the oldest commercial institutions known to humankind and will now be discussed.

Table 3.1: Advantages and disadvantages of a sole proprietorship

Advantages:
•It is simple to create. •It is the least expensive way of beginning a business. •The owner has total decision-making authority. •There are no special legal restrictions. •It is easy to discontinue.
Disadvantages:

- The owner is personally liable without limitation.
- Limited diversity in skills and capabilities is available.
- The owner has limited access to capital.
- There is lack of continuity.

3.2.4 The partnership

In many respects, a partnership is similar to a sole proprietorship and the two business forms share several of the same disadvantages. A partnership may be described as a contractual relationship between two or more persons, called partners, who operate a lawful business with the object of making a profit. Previously the number of partners was limited to 20, but under the Companies Act (No. 71 of 2008) this restriction no longer applies. It is, therefore, in principle, possible to have an unlimited number of partners. This may lead to greater diversification of skills in the business. Partners may be natural or juristic persons. This means that a company or a close corporation may be a partner. In terms of the Consumer Protection Act (No. 68 of 2008), members of the public are required to register the name of their partnership with the Companies and Intellectual Property Commission.

The essential characteristics of a partnership are that each partner has to contribute something to the partnership, the partnership must be carried on for the joint benefit of the partners and each partner should have the expectation of sharing in the profit. Owing to the fragility in terms of the continuation of partnerships and the risks associated with this particular business form, a relationship of utmost good faith is required between partners.

A partnership does not have legal (juristic) personality. The partnership, therefore, has no separate estate from the partners, and their personal assets are exposed to the risks of the business. The partners in their personal capacity, rather than the partnership as such, jointly enter into all transactions or contracts. The assets contributed to or accumulated by the partnership belong to all the partners jointly as co-owners. The partners are also jointly liable for all the partnership debts in the course of the partnership.

Although a partnership is not a juristic person, the law nevertheless regards a partnership as an entity for certain limited purposes:

- Firstly, the partners may institute legal proceedings in the name of the partnership instead of citing all the partners jointly on the summons. The partners may also be sued in the name of the partnership, for example, 'Moodley and partners' or 'Ndlazi and Smith Financial Advisers'.
- Secondly, the law treats the partnership estate as a separate estate for purposes of sequestration. Although the estates of the partners will also be sequestrated simultaneously when the partnership estate is sequestrated, the partnership creditors will have to prove their claims against the partnership estate and not against the estates of the individual partners.

The continued existence of a partnership depends on the continued involvement of the partners. It is also largely dependent on the legal capacity of the partners. Should a partner be declared insolvent or mentally incapacitated, the partnership would usually be terminated. Whenever there is any change in the member-ship of the partnership, for example, through the death or withdrawal of a partner or the admission of a new partner, the partnership dissolves automatically. It is, however, possible for the remaining partners to form a new partnership. In most cases, the partnership agreement will provide for such a partnership change between the existing partners.

During the existence of the partnership, the partners are jointly liable for all claims against the partnership, regardless of who was responsible for bringing about the claim. A creditor must either sue all the partners jointly or sue in the name of the partnership. If the partnership assets are insufficient to meet the claim of the creditor, the partners are liable for the debt out of their personal estates. The personal possessions of the partners are, therefore, not protected against any claim. Once a partnership has been dissolved, the partners are jointly and severally liable for partnership debts. This means that a creditor can recover the full debt from one partner only, leaving it to the partner who settled the debt to claim the necessary proportionate contributions from his or her co-partners.

The partners have joint control and authority over the business. However, the partners can adjust the control and authority aspect in their partnership agreement. For example, one or more partners can be excluded from representing or participating in the management of the partnership. This would, however, not necessarily exclude liability in terms of transactions concluded by a partner who has been excluded in this way. The principle of mutual mandate provides for liability of the partners for contracts concluded by any partner in the name of the partnership if the transaction falls within the scope of the partnership business. This is a form of implied authority and, consequently, no express authority has to be given to a partner for this principle to apply. Therefore, the partners will, during the existence of the partnership, be held jointly liable in terms of any transaction concluded by a partner if the contract is not outside the scope of the business. A partner who has been excluded from participating in management who concludes a contract within the scope of the partnership will, however, be in breach of his or her fiduciary duty to his or her co-partners.

The joint management of the partnership can lead to problems if the partners have different opinions or work ethics. A partnership may even be terminated as a result of the personal circumstances of its partners or their incompatibility in running the business. In this respect, the partnership is less adaptable to changing circumstances than a sole proprietorship. However, the partnership's broader authority can mean improved management ability because the business draws on the knowledge and experience of a greater number of people. It also allows for division of labour and specialisation, with the additional advantage that individual partners are exposed to less pressure than a sole proprietor. A partnership usually has better capital-acquisition potential than a sole proprietorship because there are more people who can contribute and who can provide security for credit.

It is a requirement for a valid partnership that each partner must make an initial contribution to the partnership. A contribution can consist of anything that has a monetary (economic) value, including money, property, services, knowledge or skill. If the partnership contract does not specify how the profits will be divided, the division will be done in proportion to the value of each partner's contribution.

A partnership is established by concluding a contract. There are no formal requirements for setting up a partnership. A partnership contract may be concluded orally, in writing or even tacitly (that is, through certain behaviour). However, it is customary and preferable for the contract to be concluded in writing. The contract makes provision for matters such as the nature and goals of the business, capital contributions by individual partners, profit sharing, management and dissolution of the business.

A partnership is not a separate taxpayer. As the partnership income belongs to all the partners jointly in specific proportions, each partner is taxed individually on his or

her share of the income. The partners also deduct the partnership expenses in the same proportion as the income. The income tax payable on each partner's share of the partnership income will depend on his or her tax status and other income. In general, transfer of ownership of assets of the partnership is more complicated than in sole proprietorship as more people are involved and the provisions of the partnership agreement must be complied with. The partnership is automatically dissolved by the death of the partner or change in the membership. The advantages and disadvantages of a partnership are reflected in Table 3.2.

Table 3.2: Advantages and disadvantages of a partnership

Advantages:
•There is ease of formation. •Diversification of skills and abilities of partners. •Legal (juristic) and natural persons may be partners. •There is increased opportunity for accumulation of capital. •There are minimal legal formalities and regulation.
Disadvantages:
•The personal liability of partners for the partnership activities. •The relative difficulty in disposing of an interest in the partnership (the partnership will terminate in any event if the membership). •The potential for conflict between partners. •Lack of continuity (succession is only possible through an agreement. However, a new partnership will be formed

Critical thinking

There is an old saying in business that you do not do business with family and friends as this could result in difficult relationships in future. If you were to select a business format with the option to choose between a sole enterprise and a partnership, which would you choose, given the fact that you have rich siblings who could assist you in the financing of the business?

3.2.5 The close corporation

A **close corporation** has characteristics of both a partnership and a company. It has the advantage of being a legal (or juristic) person that exists separately from its members. A close corporation may have one or more members, but not more than ten. Juristic persons may not be members of a close corporation, except in certain very limited circumstances, specified in the Close Corporations Act (No. 69 of 1984), where they may be members in the capacity of an official representative. The core characteristic of the close corporation is that it is closed in the sense that the members both own and control the close corporation. The interest of a member is expressed as a percentage and the total interest of members must always amount to 100 per cent. The name of a close corporation must end with the abbreviation 'CC'.

As a juristic person, a close corporation has its own rights, assets and liabilities. A close corporation has the capacity and powers of a natural person insofar as this may apply to a juristic person. Therefore, a close corporation is even entitled to certain fundamental rights as set out in the Constitution of the Republic of South Africa, 1996.

Because the close corporation has legal personality, its continued (perpetual) existence is not influenced by the withdrawal or entry of members. It can also withstand changes in the personal circumstances and legal status and capacity of its members.

The members of a close corporation are generally not liable for the debts and liabilities of the close corporation. They enjoy limited liability. Therefore, the members' personal assets in their private estates are not at risk of being lost in the business. However, the Close Corporations Act (No. 69 of 1984) imposes personal liability on members for certain violations of its provisions. Personal liability is also imposed for carrying out the business of the corporation recklessly, fraudulently or with gross negligence, or for abusing the juristic personality of the corporation.

The members share the management and control of a close corporation on an equal basis. The Close Corporations Act (No. 69 of 1984) regulates the internal operation of the close corporation. The Act provides that certain persons, such as minors or insolvents, may not participate in the management of a close corporation. Decisions are generally taken by majority vote, but in some specific instances, a majority of 75 per cent or even the consent of all the members is required.

If the corporation has two or more members, they may enter into an association agreement that alters certain aspects of the internal functioning of the corporation. An association agreement may, for example, provide that only certain members will participate in the management of the corporation, or that authority to conclude contracts on behalf of the close corporation will depend on the percentage of each member's interest. Notwithstanding the existence of such agreement, any member of the close corporation who contracts with a non-member is regarded as an agent who is able to bind the close corporation to any contract, even if such a contract falls outside the scope of business of the corporation. The close corporation will only escape liability if the non-member knew or should reasonably have known that he or she did not have the authority to represent the corporation. This arrangement protects third parties contracting with the corporation, but it exposes the members of the corporation to risk. Therefore, it is important that members are selected carefully. Any member of the close corporation who acts without authority will be liable to the corporation as a result of his or her breach of his or her fiduciary duties towards the close corporation. Members are expected to carry out their duties honestly and in good faith, and not to exceed their powers.

The capital-acquisition potential of a close corporation is higher than that of a partnership, mainly because members may be more inclined to contribute to a corporation knowing that they do not stand to lose more than what they have invested. Each person who becomes a member of a close corporation must make a contribution with a monetary (economic) value. This could be in money, property or even services in connection with the formation of the corporation. Services are, however, not an acceptable contribution for a new member joining an existing corporation. The amounts a member may be inclined to contribute to a corporation need not be in direct proportion to another member. Two members who have contributed the same amount of money to a corporation may, for example, agree that one of them will hold a 60 per cent member's interest and the other a 40 per cent member's interest. A close corporation can also use loan capital and members are often required to bind themselves as sureties for credit incurred by the corporation. Although this, in effect, removes the advantage of limited liability, it enables the corporation to obtain increased funding.

A close corporation may not make any payments to members in their capacity as members (for example, profit distribution or repayment of contributions) unless the solvency and liquidity tests are satisfied. The solvency test means that after payment, the corporation's assets must still exceed its liabilities, based on a reasonable valuation. A corporation meets the liquidity test if before the payment is made it can pay its creditors as payment becomes due and after the payment is made it will still be able to pay its debts as they become payable in the ordinary course of business.

As stated above, close corporations are mainly regulated by the Close Corporations Act (No. 69 of 1984). The legal prescriptions contained herein are not strict. A close corporation's sole registration document is called a founding statement. The founding statement contains details such as the proposed name of the corporation, the nature of the business, the personal details of members and their interests in the corporation. The founding statement is similar to the Memorandum of Incorporation of a company. Although a founding statement is registered, it is not open for public inspection and nobody is deemed to know its contents. In terms of the Companies Act (No. 71 of 2008) it is no longer possible to register new close corporations. Companies may also no longer be converted into close corporations. Certain close corporations are also required to comply with stricter legal requirements relating to auditing of financial statements than others. This is very unfortunate, especially because registration statistics evidence a tendency to incorporate close corporations rather than companies. Of the number of close corporations registered, the figures also reveal a relatively high subsistence rate when compared to that of all forms of companies. The Companies Act (No. 71 of 2008) aims to make companies a more favoured option by introducing a simpler registration process. It is envisaged that close corporations may eventually be phased out if the simplifications introduced prove workable for smaller businesses.

The Companies Act (No. 71 of 2008) and the Companies Amendment Act (No. 3 of 2011) amended and repealed various sections of the Close Corporations Act (No. 69 of 1984). It is aimed at levelling the playing field between close corporations and private companies. Identical regulation requirements apply to close corporations and private companies.

The following aspects, which were previously only applied in respect of companies, are now applicable to close corporations:

- The criteria for names and the new voluntary procedure for the reservation of names apply.
- Close corporations are required to prepare annual financial statements within six months of the end of the financial year to which they relate (this was previously nine months). Annual financial statements must be audited if so required by the Companies Regulations, 2011. In other words, whereas close corporations were required previously only to appoint an accounting officer, certain close corporations (in the same circumstances as in private companies) are now obliged, in addition to this review, to have a formal audit performed on their financial statements. This does not mean that the close corporation is exempted from the requirement in the Close Corporations Act (No. 69 of 1984) to have an accounting officer. Affected close corporations must abide by both pieces of legislation. Close corporations are given the option of opting to comply with the enhanced transparency and accountability requirements in Chapter 3 of the Companies Act (No. 71 of 2008) by appointing an auditing committee and a secretary, and complying with the rotation requirement as applied in companies in respect of auditors. As it is not compulsory, however, it is doubtful that many close corporations will choose to comply voluntarily.

- The business-rescue procedure applicable to companies may be utilised by close corporations in financial distress.
- The definition of ‘control’, and hence the terms ‘related’ and ‘interrelated’ persons as used in the Companies Act (No. 71 of 2008), also applies to close corporations.
- A member of a close corporation can be declared a delinquent or placed under probation in the same way as a director of a company in terms of the Companies Act (No. 71 of 2008).
- Provisions relating to the dissolution and winding up of companies are the same for close corporations.
- The complaints, investigations and adjudication procedures before the Takeover Regulation Panel or Companies Tribunal are on par for companies and close corporations.

Existing close corporations will continue to exist indefinitely, but must comply with both the legal requirements of the Companies Act (No. 71 of 2008) as well as the remaining provisions of the Close Corporations Act (No. 69 of 1984). Close corporations are, therefore, subjected to more onerous administrative duties and arrangements than before the enactment of the Companies Act (No. 71 of 2008). The benefit of simple regulation in close corporations is consequently negated by the requirement to adhere to both the Close Corporations Act (No. 69 of 1984) and the Companies Act (No. 71 of 2008).

Members of a close corporation may decide to convert the business into a company should they wish to do so. This can be done by lodging a notice of conversion, a certified copy of a special resolution by the members approving the conversion and a new Memorandum of Incorporation (the founding document for a company) with the Companies and Intellectual Property Commission. A filing fee must be paid, and a notice of the conversion published. The Commission must effect necessary changes resulting from the conversion and any resultant name changes. The effect of conversion from a close corporation to a company is as follows:

- Each member of the close corporation will have an option to become a shareholder of the company.
- The juristic person that existed as a close corporation will continue to exist in the form of a company.
- All the assets, liabilities, rights and obligations of the close corporation will vest in the company.

If any legal proceedings were instituted before the registration as a company by or against the close corporation, they may be continued by or against the company. A close corporation will also not be absolved from personal liability incurred in terms of the Close Corporations Act (No. 69 of 1984) by converting into a company. The Companies Act (No. 71 of 2008) contains provisions similar to those contained in the Close Corporations Act (No. 69 of 1984). For instance, the provisions prohibiting reckless and fraudulent trading and the provision providing for disregarding of the separate legal personality in companies and close corporations are very similar.

The conversion would naturally place both an administrative as well as a financial strain on the members of the close corporation. The business, depending on the type of company it is changed into and its public interest score, may be required to comply with the enhanced accountability requirements as contained in the Companies Act (No. 71 of 2008).

A close corporation is a separate taxpayer. For purposes of the Income Tax Act (No. 68 of 2008), close corporations are treated as companies and the distributions they

make to their members are regarded as dividends. The taxable income of a close corporation is, therefore, taxed at the fixed corporate tax rate of 28 per cent. A withholding tax on dividends is payable at a rate of 15 per cent on the gross amount of all distributions of income made to members. Therefore, the total income tax payable by the corporation and by the members on the profits generated by the corporation will be influenced by the extent to which income is retained in the close corporation or distributed to members. This flexibility can be used to the advantage of members.

A member's interest can be transferred to another individual who will then become a member of the close corporation. New members can also acquire a member's interest directly from the corporation by making a contribution, followed by an adjustment to the percentages of member's interest held by other members. In such a case, the relative percentages of the remaining members will be adjusted. Transfers or acquisitions of a member's interest must be in accordance with the association agreement or, if there is no such an agreement, with the approval of all the members of the corporation. A transfer of a member's interest does not affect the existence of the corporation. Therefore, a member's interest is more easily transferable than that a partnership interest. The advantages and disadvantages of a close corporation are shown in Table 3.3.

Table 3.3: Advantages and disadvantages of a close corporation

Advantages:
•It has the advantages attached to separate legal (juristic) personality. •Members enjoy the benefit of limited liability. •There is increased capital-acquisition potential. •Management is relatively simple. •It enjoys continuity (perpetual existence).
Disadvantages:
•Membership is limited to ten persons. •Juristic persons may not be members. •No new close corporations may be registered. •Certain close corporations are subject to stricter accountability criteria under the Companies Act (No. 71 of 2008), Amendment Act (No. 3 of 2011) and the Companies Regulations, 2011.

3.2.6 The company

The **company** developed to meet business people's need to obtain more capital than they could through a sole proprietorship or partnership. Companies as business forms also bridged many of the deficiencies and undesirable features of partnerships. People eventually came to accept the notion that, from a legal point of view, there could be a fictitious person with rights and duties who is able to participate in commercial life and whose existence would not depend upon the life of a natural person or persons. Businesspeople could obtain large sums of money through such a separate legal entity so that they could undertake commercial ventures that individuals could not afford, to the benefit of the entire community. Companies enjoy all the benefits attached to a separate legal (juristic) personality, usually combined with limited liability of the shareholders (in profit companies) or members (in non-profit companies), as well as potentially unlimited capital-generating capacity.

The company is characterised by the separation of ownership and control. This means that a formal distinction is made between the members or shareholders of the company and its managers and directors.

The Companies Act (No. 71 of 2008) provides for the incorporation of two types of companies:

•Profit companies; and

•Non-profit companies.

An incorporated association not for gain, previously known as a Section 21 company under the Companies Act (No. 61 of 1973), is now referred to as a non-profit company (NPC). These companies are usually incorporated for a humanitarian or public purpose such as the promotion of a specific sport, cultural activity or charity. NPCs do not issue any of their profits to their members, but use these profits to promote the specific purpose for which the company was formed. NPCs must have at least three directors, but need not necessarily have any members. Upon winding up and dissolution of a NPC, any assets or profits that are available cannot be distributed to the members. They can only expect reasonable remuneration for their services as director, and they may not derive any other benefits. Therefore, the aim of a non-profit company is not to make a profit for personal benefit.

The most common type of company is the for-profit company. Profit companies are divided into four different classifications: public companies, private companies, state-owned companies and personal liability companies.

A private company and a personal liability company must have at least one director, and a public company or a non-profit company must have a minimum of three directors. In addition to the minimum number of directors that the company must have, it must satisfy the requirement to appoint an audit committee or a social and ethics committee, if applicable.

The Memorandum of Incorporation of a private company must contain some restriction on the transferability of its securities. The securities in a public company are freely transferable.

The general public cannot subscribe to the shares of a private company. A private company can, therefore, not list its shares on the stock exchange. Public companies may raise capital by issuing shares to the public. The public can be invited to buy shares in the company by means of a prospectus. A public company is also eligible to list its shares on the stock exchange.

The name of a private company must end with the words '(Pty) Ltd'. The name of a public company must end in the word 'Ltd'. Certain professions allow their members to form a certain type of company instead of practicing in a partnership. The members, who usually have to be directors as well, are jointly and severally liable for the contractual debts of the company. This is known as a personal liability company. The name of a personal liability company must be followed by 'Inc.' or 'Incorporated'. Personal liability companies must meet the criteria applicable to private companies. Only one person is required to form a personal liability company and there must be at least one director. This type of company is mainly used by professional associations of people such as attorneys or auditors. The Memorandum of Incorporation of a personal liability company must express that creditors may hold directors jointly and severally liable for the company's contractual debts and liabilities. Members of the public (outsiders to the company) are deemed to know of such a provision if the company's Notice of Incorporation includes a prominent statement drawing attention to the inclusion of such a clause in the company's Memorandum of Incorporation and where it

is situated. If this is done, third parties or outsiders who contract with this type of company are deemed to be aware of the content of the company's Memorandum of Incorporation.

While all types of companies are subject to a number of legal regulations, a private company is not as strictly controlled as a public company.

A state-owned company's name must include the end expression '(SOC Ltd)'. This type of company must be registered in terms of the Companies Act (No. 71 of 2008) and must either be listed as a public entity in terms of the Public Finance Management Act or owned by a municipality. Examples of state-owned companies are ACSA (SOC Ltd) and South African Airways (SOC Ltd). These companies are obliged to appoint company secretaries and audit committees. They are subject to the stricter accountability provisions contained in Chapter 3 of the Companies Act (No. 71 of 2008) except if or to the extent that the particular company is exempted from complying.

A company is a legal (juristic) person and therefore has its own rights, assets and liabilities. A company exists independently from its members or shareholders and has the potential for perpetual existence. Therefore, the personal estates of shareholders remain unaffected when claims are instituted against a company. Like a close corporation, a company has the same capacity and powers that a natural person enjoys, except insofar as it is impossible for a juristic person to have such powers. Therefore, the capacity of companies to conclude contracts that even fall outside the scope of the company's business is not limited. The main and/or ancillary objects of the company's business do not even have to be stated in the Memorandum of Incorporation.

However, it is possible for companies to restrict their capacity and powers in the Memorandum of Incorporation. The Companies Act (No. 71 of 2008), however, determines that such a limitation will not render a contract concluded contrary to any such restrictions or limitations contained in the Memorandum of Incorporation invalid.

The shareholders and directors are generally not personally liable for the debts of the company. An exception to this rule is contained in personal liability companies, where the directors are personally liable for all contractual debts of the company. Shareholders enjoy limited liability as they stand to lose only the consideration they paid in exchange for their shares. In exceptional circumstances, the directors and controlling shareholders may be held personally liable for debts of the company if the juristic personality of the company has been abused or if the company's business has been conducted recklessly. The Companies Act (No. 71 of 2008) also contains a provision to the effect that persons guilty of committing fraud or who abuse the separate juristic personality of a company can be held accountable by the courts if it would cause an unconscionable injustice to maintain the separation between the company and the guilty persons inside it. As has been stated, a distinction is made between ownership and control. A company has two organs:

- **The shareholders in general meeting.** The general meeting of shareholders or members (as they are called in non-profit companies) makes broad policy decisions and exercises control over the company's affairs through its right to appoint and remove directors and to amend the company's Memorandum of Incorporation, which govern the internal operation of the company. The voting rights of shareholders are linked to the number of shares they hold in the company. Decisions at meetings are normally taken by means of a vote.
- **The board of directors.** The administration of the company is entrusted to its directors. The precise division of powers between the board of directors and the general meeting is determined by the Memorandum of Incorporation. The day-to-

day management of the company is usually delegated to the board of directors. At least 50 per cent of the directors must be appointed by the general meeting, and their functions and powers may be defined in the Memorandum of Incorporation. These functions are jointly exercised by the directors (as the board of directors) by means of a majority vote. The board may delegate some of its functions and powers to a managing director.

The structure of a company facilitates the appointment of specialised managers with diverse areas of expertise and experience. This is usually an advantage, but there is always a risk of decision-making being delayed owing to differences of opinion.

A company's capital is made up of share capital, representing the consideration the company receives in exchange for the shares it issues, as well as accumulated funds and loan capital. As far as the potential for capital acquisition is concerned, the company – the public company in particular – has a distinct advantage over sole proprietorships, partnerships co-operatives and close corporations. This is because the general public can be invited to invest capital and acquire shares in a public company. In public companies, the transfer of ownership takes place through the unlimited and free transfer of shares. Ownership is transferred through the private sale of shares or, in the case of a listed company, through transactions on the stock exchange. The transfer of shares usually has no influence on the activities of the company and the company therefore has an unlimited lifespan.

Shares in a private company are not freely transferable. Transfer is usually subject to the approval of the board of directors. A shareholder who wants to sell his or her shares therefore has to find a buyer who is acceptable to the board. In most instances, a shareholder has to offer the shares to the remaining shareholders first in proportion to their existing shareholding. The shareholder may only transfer the shares to an outsider if the other members are not prepared to acquire them at the same price. In other words, a preemptive right exists in favour of other shareholders for transfer of shares in a private company. Despite these limitations, the transfer of shares in a private company is unlikely to influence its activities or the continued existence of the business. In personal liability companies and state-owned companies the method of transfer of shares may also be set out in the Memorandum of Incorporation.

The shares of public companies may further be listed on a stock exchange, which increases the ability to raise capital even further. The strict regulation of companies, coupled with compulsory financial disclosure, also makes financial institutions more willing to provide loan capital to a company than to other forms of enterprise. The capital-acquisition potential of a company can be further enhanced if shareholders or directors are prepared to provide additional loan security in their personal capacities. This often happens in practice, especially in the case of private companies.

A shareholder's interest in the company is represented by the number of shares that he or she holds in the company. Shareholders share in the profits of a company when a dividend is declared, or a payment by virtue of shareholding is authorised. Distributions by the company are subject to compliance with the criteria of solvency and liquidity.

A company is subject to many more legal prescriptions than the other forms of enterprises, which translates into increased costs as well. However, as discussed above, the legal prescriptions for close corporations have become equivalent to those applicable to private companies.

Companies are mainly regulated by the Companies Act (No. 71 of 2008), the Companies Amendment Act (No. 3 of 2011) and the Companies Regulations, 2011. Other legislation also applies to companies – for instance, the Companies Act (No. 61 of

1973) still regulates winding up of insolvent companies, the Securities Services Act (No. 36 of 2004) regulates aspects of listed companies and the Auditing Profession Act (No. 26 of 2005) regulates certain aspects concerning disclosure and auditors. The Companies Act (No. 71 of 2008) requires that a company register a Memorandum of Incorporation (the sole founding document) with the Companies and Intellectual Property Commission (the Commission), which replaced the Registrar of Companies and Intellectual Property (CIPRO). This forms the document that sets out rights, duties and responsibilities of shareholders, directors and others within and in relation to a company and other matters. Provisions in the Memorandum of Incorporation may be amended from time to time.

The Companies Act (No. 71 of 2008) provides for a simple procedure of registration. A company is registered with the Commission by filing a **Memorandum of Incorporation** and a **Notice of Incorporation** and paying the prescribed filing fee. Although provision is made for name reservations, it is possible for profit companies to be registered temporarily under their registration numbers until a suitable name is registered. NPCs must reserve a name that adheres to the requirements as set out in the Companies Act as well as the prescriptions contained in the Business Names Act (No. 27 of 1960) before registration is possible. The Memorandum of Incorporation governs the internal as well as the external relationships of the company. This document contains the name, objectives and internal management rules, among other things. It is also possible for the board of directors to adopt company rules governing the management of the company on matters not dealt with in the Companies Act or the Memorandum of Incorporation. These rules may not conflict with the Companies Act (No. 71 of 2008) or the Memorandum of Incorporation. The Memorandum of Incorporation and the rules are binding between the company and each shareholder or member, the shareholders or members among each other, between the company and each director or prescribed officer and between the company and any other person serving the company as a member of a committee of the board. Although the Memorandum of Incorporation and company rules (if adopted) are available for public inspection, persons dealing with the company are not generally presumed to be aware of the contents of these public documents.

The Companies Act (No. 71 of 2008) has changed the face of South African companies completely. Except for Chapter 14 dealing with the winding up of companies, the whole of the Companies Act (No. 61 of 1973) has been repealed.

Public companies have to comply with stricter requirements concerning accounting records, financial reporting, auditing, minutes of meetings, registers of shareholders and annual returns than private companies and non-profit companies.

The Companies Act (No. 71 of 2008) has increased the powers and responsibilities of directors. Previously, the powers of the board of directors of a company were balanced with those of the general meeting of members of the company. However, under the Companies Act (No. 71 of 2008) and its regulations, the effective governance of corporations and liability for non-compliance has been placed squarely upon the shoulders of the board of directors. The duties of directors are partially codified in the legislation. However, these duties do not exclude any of the common-law duties already applicable in respect of directors. These duties are in addition to the existing duties of directors. In short, directors are required to disclose any personal financial interest that they may have in the matters of the company; not to abuse the position of director of information acquired by virtue of his or her directorship to acquire a personal benefit or to benefit someone else or to cause harm to the company or a subsidiary of the

company; to disclose any material information that comes to his or her attention to the board; and to act in good faith and for a proper purpose. Directors are obliged to act in the company's interest.

The rights of shareholders to hold directors and prescribed officers accountable have been extended. Shareholders and other persons with an interest may, in terms of the Companies Act (No. 71 of 2008), hold a director accountable for any financial losses they may have suffered resulting from a failure properly to perform his or her duties under the Act. In addition, a procedure for the removal of directors through an ordinary resolution of the shareholders is provided for. The provision dealing with removal of directors also provides for removal of a director by the rest of the board of directors under certain circumstances. Shareholders also have alternative options of declaring a director delinquent or placing him or her under probation.

In acknowledgement of the fact that the harsh penalties for non-adherence connected to the onerous duties of directors may diminish the pool of qualified, suitable and perhaps even willing directors, a version of the business judgment rule has been adopted. In terms of this rule, a director is presumed to have acted with the required degree of care and skill and in the company's best interest in making a decision if it can be proven that the decision under scrutiny had been made on an informed basis, devoid of a personal interest or a conflict of interest and in the belief that it was in the company's best interest. This inclusion in the Companies Act (No. 71 of 2008) may possibly counteract the negative impact the conceived stricter liability of directors could have for the advancement of entrepreneurship and growth of profitable, efficient South African companies.

A company is a taxpayer. It is currently taxed at a fixed percentage of 28 per cent on its taxable income. Small companies with a limited income are taxed on a sliding scale up to a specific limit. A withholding tax on dividends is payable by profit companies at a rate of 15 per cent on the gross amount of the net dividends distributed. The advantages and disadvantages of a company are summarised in Table 3.4 below.

Table 3.4: Advantages and disadvantages of a company

Advantages:
•Legal (juristic) and natural persons may be shareholders or members of companies. •There are no restrictions on the number of shareholders who may invest in companies. •Shareholders or members have limited liability (except in personal liability companies where directors are persona contractual debts). •The ability exists to raise large amounts of capital (especially in public companies where shares can be listed on t exchange and are freely transferrable to the public). •There is separation of ownership and control. •There is continuity (perpetual existence). •There is transferability of shares.
Disadvantages:
•There is a high degree of legal regulation. •There are high operational costs.

3.2.7 The business trust

The **business trust** is becoming an increasingly popular enterprise form. A business trust is a trust that has the object of conducting a business in order to generate a profit.

Business trusts developed out of the ordinary trust. A trust is established through a trust deed in terms of which the founder of the trust places assets under the control of a trustee to be administered for the benefit of the beneficiaries. The trust deed may consist either of a written contract or a valid testamentary writing. The trust assets and the beneficiaries must be clearly identified in the trust deed. There is no limit to the number of beneficiaries. Beneficiaries may be natural or juristic persons. A trust is a separate entity from its trustees and beneficiaries, much like a company or a close corporation. A trust is also not owned by anyone. It does not terminate unless by agreement or if it is sequestrated as a result of its inability to pay its debts. Trusts are, however, not creatures of statute. They are not registered with the Commission like companies or co-operative societies. A trust is formed when a valid trust deed is accepted by the Master of the High Court having jurisdiction.

A trust does not have legal (juristic) personality. However, in terms of some legislation, trusts are considered to exist as legal persona. The Companies Act (No. 71 of 2008) also includes trusts under its definition of juristic persons. What exactly was intended by this inclusion is unclear. It could possibly be that the legislature intends to prevent avoidance of corporate law principles by trusts that are associated with groups of companies.

The trustee owns the trust assets in an official representative capacity and is also liable for the debts of the trust in his or her capacity as trustee. However, as the trustee is liable only out of the trust assets and not in his or her personal capacity, the effect is similar to limited liability. A trustee is considered to have two separate estates: a personal estate out of which his or her personal debts are paid and the trust estate, which is liable for trust debts only. A trust can be set up for any period of time. Therefore, it is capable of perpetual existence.

The existence of a trust does not depend on the identity of the trustee or its beneficiaries.

The management of a trust is in the hands of the trustees who have to exercise their duties in accordance with the trust deed under the supervision of the Master of the High Court. Trustees cannot perform any valid act in the name of, or on behalf of, a trust before receiving valid authorisation from the Master of the High Court to do so. The court may also intervene to remove or appoint new trustees, to declare a trust valid or invalid and, in exceptional circumstances, to nominate specific beneficiaries where this is not done in the trust deed. Trustees have a duty of good faith to the beneficiaries of the trust. The trust founders are also able to exercise a measure of control over the trustees by their right to amend the trust deed. In a private business trust, the same persons are usually founders, trustees and beneficiaries of the trust. This means the management structure is similar to that of a partnership.

The capital of a trust is provided by the trust founder or founders. A trust has limited potential for capital acquisition. Loan capital may be obtainable, usually in exchange for security provided by the parties to the trust. The distribution of profits to members will generally be left to the discretion of the trustees, affording the parties maximum flexibility with regard to retention or distribution of funds.

It is easy and cheap to establish a trust. All that is required is a trust deed identifying the trust property, trustees and beneficiaries, and setting out the powers of the trustees. There is very little regulation of trusts compared with regulation of other business forms. Trusts that take investments from the public (for example, unit trusts) are, however, subject to specific regulation. The lack of regulation of trusts can be a

disadvantage if the trust deed has not been formulated properly and if trustees are not selected carefully.

A trust is regarded as a separate taxpayer. As a general rule, the trustee is seen as a representative taxpayer. Income tax on trust income is allocated according to the conduit principle. In other words, income that accrues to the beneficiaries is taxed in their hands, while income retained in the trust is taxed in the hands of the trustee as representative taxpayer. Where the entitlement of beneficiaries to income is not pre-determined in the trust deed, but is left to the discretion of the trustees, great flexibility in tax planning and structuring is possible. Transfer of the interest of a beneficiary can be achieved by a variation of the trust deed. The advantages and disadvantages of a private business trust are summarised in Table 3.5.

Table 3.5: Advantages and disadvantages of a private business trust

Advantages:
•Ease of formation. •Natural and legal (juristic) persons may be parties to a trust, whether as founder, trustee or beneficiary thereof. •Parties to a trust enjoy limited liability. •Extreme flexibility. •Absence of onerous legal regulation. •Continuity (perpetual existence).
Disadvantages:
•Limited access to capital. •Potential for conflict between parties.

3.2.8Co-operative societies

A co-operative is an autonomous association of persons, who unite voluntarily to meet common economic, social and cultural needs by means of a jointly owned and democratically controlled enterprise. A co-operative may, for instance, buy the ingredients that the members need to produce a product in bulk (for instance, flour to bake bread and cakes). The members then produce the product and the co-operative market sells it on their behalf. In our example the bread and cakes are sold to the public by the co-operative. A co-operative is a distinct form of enterprise that provides services and/or products to its members. The profits made by the co-operative (known as surpluses) are divided between its members in relation to the amount of the business each member did with the co-operative.

Note that specific forms were developed for new co-operative registration that would culminate in a more streamlined operation in terms of record keeping and administration. These forms are accessible on the Internet at http://www.cipc.co.za/.

A co-operative may be a primary, secondary or tertiary co-operative. In a primary co-operative a minimum of five natural persons need to register. Secondary co-operatives are formed by two or more primary co-operatives to provide sectoral services to its members, and may include juristic persons. Tertiary co-operatives (or co-operative apexes) are co-operatives consisting of two or more secondary co-operatives whose object is to advocate and engage organs of state, the private sector and stakeholders on behalf of its members.

The name of a co-operative society must always indicate what the principal business of the co-operative is. If a co- operative pursues many objectives, the name must be followed by words such as 'multipurpose', or it could include 'other projects' after what is considered to be a primary function. The words 'co-operative' or 'co-op' must be part of the name and the word 'limited' or 'Ltd' must be the last word in its name unless the co-operative's constitution does not limit the liability of the members of the co-operative. A secondary co-operative must have the words 'secondary co-operative' as part of its name. A tertiary co-operative (or 'co-operative apex') must have the words 'tertiary co-operative' as part of its name.

The highest decision-making structure of a co-operative is a general meeting of members. Notably, one of the characteristics of co-operatives is democratic decision-making. Generally, each member enjoys one vote equal to that of the other members.

Anybody may become a member of a co-operative. The constitution may only restrict the persons eligible for membership if the restriction reasonably relates to the business of the co-operative set out in its constitution and to the commercial ability to provide services to prospective members. A restriction may not amount to unfair discrimination. Therefore, co-operative societies are open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination.

A co-operative has to have capacity to do anything that is necessary to carry out its objectives, subject to limitations imposed by its constitution, the Co-operatives Act (No. 14 of 2005) and any other law. The affairs of a co-operative must be managed by a board of directors. The board of directors must exercise the powers and perform the duties of the co-operative subject to the Act and the constitution of the co-operative. The board of directors remains subordinate to the members in general meeting. If a co-operative performs any act outside its functions, the co-operative and a director of the co-operative who authorised the performance of that act or who performed that act knowing that the co-operative is not empowered to perform that act is guilty of an offence.

Co-operatives are formed through registration at the special Department for Co-operative Societies, which is a subdivision of the Companies and Intellectual Property Commission. It is not restricted to agriculture and farming activities. Trading co-operatives can be used for various kinds of businesses. Relatively few co-operatives have been formed in comparison with other forms of business enterprises. By nature, co-operative societies do not lend themselves to strong business ventures. Sustainability issues due to a lack of resources and support are the main reasons.

Co-operative societies are similar to private companies in many respects. Like a private company, a co-operative society is also recognised as a legal (juristic) person once it is registered and a registration certificate is issued. Members of co-operatives also enjoy limited liability for the debts of the co-operative. Termination of a member's membership does not affect the continued existence of the business. Consequently, a co-operative society provides continuity (perpetual existence) of the business. The liability of a member of a co-operative is limited to an amount equal to the nominal value of the shares, for which the member has not paid, that the member holds in the co-operative.

A co-operative society is also similar to a partnership in the sense that the members work together for a common purpose: to meet the members' mutual or common economic, social and cultural needs.

A co-operative is incorporated as a juristic person from date of registration as reflected on its registration certificate that is issued to it by the Department. Co-operatives are jointly owned by the members.

The Department may make financial support available to co-operatives that comply with certain requirements. Co-operatives that adhere to the co-operative principles, and that consist mainly of black persons, women, youth, disabled persons or persons in rural areas, and that promote equity and participation by its members, qualify for these additional fiscal benefits.

The Co-operatives Act (No. 14 of 2005) regulates this business form. However, co-operatives are not regulated through legislation only. The constitution of a co-operative plays a very important role in the functioning of the business. It regulates the relationship between members of the co-operative and the directors. Among other things, it regulates what the principal business of the co-operative is, any restrictions in the capacity of the business, voting and decisionmaking, how meetings are to be conducted, and the powers that the board of directors has to manage the business, the requirements for membership, how funds are to be utilised and paid to members, etc.

Co-operatives strive to achieve certain economic advantages for their members through joint action on the behalf of members. The business is managed democratically by the members and specific values must be maintained for it to subsist. The co-operative principles are guidelines by which cooperatives put their values into practice. Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for others. Failure to comply with the co-operative principles could potentially lead to an investigation or inspection of the business of a co-operative or prosecution. The Registrar may also make any recommendation that is considered as being appropriate, including winding up and termination of the co-operative.

In South Africa, co-operatives are found mainly in farming communities as organisations selling and/or supplying products or products and services. Because of their distinctive features, co-operatives are not usually real alternatives to the forms of business that we have mentioned. Nevertheless, co-operative societies may assist in the creation of better socio-economic circumstances, particularly where agreements are concluded between manufacturers, small businesses and supermarkets. This practice could potentially promote cost saving and more effective marketing of produce. In addition, by combining to produce in a single pool, small producers who produce in the same enterprise can more effectively provide the market. The advantages and disadvantages of a co-operative are presented in Table 3.6 below:

Table 3.6: Advantages and disadvantages of a co-operative

Advantages:
•Co-operatives are recognised as juristic persons. •Members of co-operative societies have the benefit of limited liability. •Any person (whether a natural or juristic person) may become a member of a co-operative society. •There is no restriction on the maximum number of members in a co-operative society. •The participatory nature contributes to the achievement of outcomes that one person would not be capable of achi •Necessary services may be more accessible, and marketing, distribution and selling of produce are simplified and result. •The business form is reasonably flexible in relation to other forms of business enterprises that provide the benefit

personality. •The legislation is less stringent in its requirements than that applicable to companies. •Enabling legislation facilitates the provision of support for businesses that are owned by women, black people, you persons, or persons in rural areas.
Disadvantages:
•Co-operatives often lack the managerial requisites of operating a business as a result of a lack of skill. •The participatory decision-making structures mean that all members need some understanding of financial manag Unfortunately, all members are often not properly equipped. •Co-operatives require mentorship and support to become viable and to remain sustainable. •Unless the levels of trust between members are high, tension can develop around the use, and allocation, of mone participatory decision-making. •Business efficiency can be influenced negatively in worker co-operatives where conflicts could exist between the r of workers in their capacity as owners (to whom managers are accountable) and in their capacity as producers (wh accountable, in the context of production, to managers). •The short-term goals of members to improve their quality of life may contrast with the longer-term interests of the c economic entity.

Critical thinking

Why is the co-operative society concept not used more frequently in the South African business context?

3.2.9 Summary of legal forms of ownership

Once entrepreneurs have identified their opportunity and evaluated it, they have three options for entering the business world (as discussed in Chapter 2):

- Entering into a franchise agreement;
- Buying an existing business; or
- Establishing a business from scratch.

In all of these cases, the entrepreneur's choice of a form of business is very important. In choosing a form of enterprise, entrepreneurs must remember that their choice must reflect their particular situation. There may be a business form that is best for the entrepreneur's individual circumstances. Understanding the forms of business, and the characteristics, advantages and disadvantages of each one, is the entrepreneur's key to selecting the form of ownership that best suits him or her.

In this section, we have discussed the different forms of enterprise available to the entrepreneur. We have compared the characteristics, advantages and disadvantages of the sole proprietorship, the partnership, the close corporation, the company, the business trust and co-operative societies.

Once the entrepreneur knows what the available options are, he/she can put everything together by drawing up the business plan for the new business.

3.3 Developing a business plan for the new business

In this section, the development of the business plan for the new business venture will be examined.

3.3.1 The objectives of a business plan

For the entrepreneur starting a new business, a **business plan** is a written document that accomplishes three main objectives. The most important objective is to identify and describe the nature of the business opportunity or the new venture.

The second objective is to present a written plan of how the entrepreneur plans to exploit the opportunity. Here, the business plan explains the key variables for the success or failure of the new venture. It is a guideline for the things that must be done to establish and operate the new venture. It provides a large number of elements (such as the mission, goals, objectives, target markets, operating budgets, financial needs and so on) that the entrepreneur and managers can draw on to lead the business venture successfully. These elements, which help managers to keep the business venture on track, constitute the key components of the business plan. A business plan is therefore also a valuable managerial tool that helps the entrepreneur and his or her team to focus on charting a course for the new business.

A third objective of the business plan is to attract investors, or to persuade a bank, other institution or person who provides financial resources to lend the entrepreneur the money he or she needs to establish the new business. Careful preparation can make the difference between success and failure when trying to find capital in the financial markets.

Apart from the above-mentioned main objectives, a business plan provides many other benefits, such as:

- systematic, realistic evaluation of the new businesses' chances of success in the market;
- a way of identifying the key variables that will determine the success of the new venture, as well as the primary risks that may lead to failure;
- a game plan for managing the business successfully;
- a management instrument for comparing actual results against targeted performance; and
- a primary tool for attracting money in the hunt for financial resources.

3.3.2 Importance and necessity of the business plan

The overall importance of the business plan lies in its planning activities. Planning is the fundamental element of management that pre-determines what the business proposes to accomplish and how this is to be accomplished. Therefore, planning, and the idea of a business plan, is hardly something new. Big businesses have long been turning out annual business plans by the thousand, especially for marketing new products, buying new businesses or expanding globally. What is new, however, is the growing use of such plans by small entrepreneurs. These entrepreneurs are, in many cases, forced by financial institutions to draw up a business plan before any financial support will be considered.

The business plan is important not only to the entrepreneur, but also to his or her employees, potential investors, bankers, suppliers, customers and so on. Each group of stakeholders in the business will study the business plan from a different perspective. It is therefore clear that any business, but especially a new venture, needs to have a business plan to answer questions that various stakeholders in the venture may raise.

There are eight reasons for an entrepreneur to write a business plan:

1. **To sell the business to him- or herself.** The most important stakeholders in any business are its founders. First and foremost, the entrepreneur needs to convince him or herself that starting the business is right for him- or her, from both a personal and an investment viewpoint.

2.To obtain bank financing. Up until the late 1980s, writing a business plan to obtain bank financing was an option left up to the entrepreneur. Bankers usually took the approach that a business plan helped the entrepreneur to make a better case, though it was not an essential component in the bank's decision-making process. However, banks and government-supported organisations that assist entrepreneurs to obtain finance now require entrepreneurs to include a written business plan with any request for loan funds. As a consequence, obtaining money from a bank or assisting organisation is tougher than it has ever been, and a business plan is an essential component of any effort to convince banks about financing a new business. Today, even an excellent business plan is not a guaranteed way of obtaining capital from the banks.

3.To obtain investment funds. For many years, the business plan has been the key to unlock venture capital or informal capital from private investors. Remember that bank financing is not the only option for obtaining funding for a new business and that private venture capital has been the source of financing of some of the biggest corporations in the world.

4.To arrange strategic alliances. Joint research, marketing and other collaborative efforts between small and large companies have become increasingly common in recent years, and these require a business plan to convince the large company to get involved.

5.To obtain large contracts. When small businesses seek substantial orders or ongoing service contracts from major corporations and government institutions, the corporations often respond (perhaps somewhat arrogantly) as follows: 'Everyone knows who we are, but no one knows who you are. How do we know you'll be around in three or five years to provide the parts or service we might require for our product?' For this reason, entrepreneurs are required to have a business plan.

6.To attract key employees. One of the biggest obstacles that small, growing businesses face in attracting key employees is convincing the best people to take the necessary risk and to believe that the businesses will thrive and grow during the coming years.

7.To complete mergers and acquisitions. No matter which side of the merger process the entrepreneur is on, a business plan can be very helpful if the entrepreneur wants to sell the business to a large corporation.

8.To motivate and focus the management team. As smaller businesses grow and become more complex, a business plan becomes an important component of keeping everyone focused on the same goals.

3.3.3Stakeholders in a business plan

There are internal as well as external stakeholders (see Figure 3.1).

Figure 3.1: Stakeholders in a business plan

Each category is discussed in the sections that follow.

3.3.3.1Internal stakeholders

THE MANAGEMENT TEAM

A written business plan is essential for the systematic coverage of all the important features of a new business. It becomes a manual for the entrepreneur and his or her management team for establishing and operating the venture. The following aspects are of primary importance to the entrepreneur and his or her team:

- The vision that the entrepreneur has for the new business;
- The mission that defines the business;
- An overview of the key objectives (this is derived from the mission statement); and
- A clear understanding of the overall strategy for accomplishing the objectives, as well as a clear understanding of the functional strategies (marketing strategy, financial strategy, human resources strategy and so on) that form substantial parts of the business plan.

EMPLOYEES

From the employees' point of view, there is also a need for a business plan. More specifically, employees need to have a clear understanding of the venture's mission and objectives to be able to work towards attaining the objectives. A business plan also serves to improve communication between employees and to establish a corporate culture. A well-prepared plan provides employees with a focus for activities. The business plan also helps prospective employees to understand the emerging culture of a young business. It is important that managers and employees contribute to the development of the business plan to establish ownership of the plan among them.

3.3.3.2 External stakeholders

The business plan is even more important to outsiders, on whom the entrepreneur depends for the survival and success of the venture. Indeed, the importance of the business plan may be said to revolve around 'selling' the new business to outsiders, who may include the customers, investors and banks.

CUSTOMERS

When small businesses seek substantial orders or ongoing service contracts, major customers always want assurance that the business will still be around in three- or five-years' time to provide the parts or service they might require for the product. Customers are almost always impressed by a business plan, as it proves to them that the entrepreneur has thought about the future.

INVESTORS

Almost everyone starting a business faces the task of raising financial resources to supplement their own resources (personal savings, investment in shares or property and so on). Unless the entrepreneur has a wealthy relative who will supply funds, he or she will have to appeal to investors or bankers to obtain the necessary funds. Very few investors or financial institutions will consider financial assistance without a well-prepared business plan.

Investors have a different interest in the business plan from the interest of other stakeholders, and if the entrepreneur intends to use the business plan to raise capital, he or she must understand the investor's basic perspective. A prospective investor has a single goal: to earn a return on the investment, while at the same time minimising risk. While many factors may stimulate an investor's interest in the venture, certain basic elements of a business plan attract (or repel) prospective investor interest more than others.

The matrix in Figure 3.2 presents an evaluation of business plans from the investor's point of view. Only certain basic indicators have been included.

BANKS

Banks are a common source of debt capital for small businesses.[2] To improve the chance of obtaining bank loans or what is known in South Africa as overdraft facilities, the entrepreneur should know what banks look for in evaluating an application for such a loan. Most banks use the four Cs to evaluate a loan application: capital, collateral, character and conditions.

- **Capital**. A small business must have a stable equity base of its own before a bank will grant a loan. The bank expects the small business to have a capital (equity) base of investment by the owner/s before it will make a loan. South African banks generally insist on at least 50 per cent equity.
- **Collateral**. This includes any assets the owner pledges to a bank as security for repayment of the loan. Bankers view the owner's willingness to pledge collateral (personal or business assets) as an indication of the entrepreneur's dedication to making the venture a success.
- **Character**. Aspects of the owner's character (such as honesty, competence, determination, ability and a good track record) play a critical role in the bank's decision to grant a loan.
- **Conditions**. The conditions surrounding a loan request also affect the bank's decision. Banks will consider factors relating to the business operation, such as potential market growth, competition and form of ownership, as well as the current state of the economy. The poor world economy since 2008 has changed conditions drastically and has resulted in banks being very reluctant to provide working capital to small businesses.

Figure 3.2: Matrix for the evaluation of business plans

CASE STUDY: The role of banks in funding small business in South Africa[3]

Banks in general have a vital role to play in the optimal functioning of the economy and especially in the process of directing the flow of capital between households and businesses. This is called a virtual spiral where banks use money that is deposited by households (and on which it pays a small amount of interest) to lend out to businesses on the medium to longer term at a much higher interest rate. The difference in margin that is created is then part of the profits generated by the bank, which is then shared in the form of salaries, bonuses and dividend payments to shareholders. Obviously, there are some risks involved for the banks in that some businesses end up not being able to repay the amount borrowed or the interest that is being charged. Banks, however, usually demand surety (collateral for example in the form of fixed assets) to cover these risks that they take. There is however rising concern that banks are not really fulfilling this function to provide business loans, especially to start-up small businesses in South Africa. Looking in general terms to banking activity in South Africa it would seem that banks are more interested in funding existing businesses with a track record. Figures indicate that banks are providing loans to existing larger businesses in various formats, one of which is providing overdraft facilities on their current account, while another is in the form of mortgages to assist existing businesses to acquire buildings, etc. However, it seems that banks are loath to perform the basic function of lending money to new business start-ups, especially those without collateral.

This problem with the funding of small businesses is not unique to South Africa but is prevalent in Africa as a whole. The problem is especially pertinent to small businesses with fewer than nine employees and small and medium enterprises with female owners as well as entrepreneurs operating in the informal sector, such as in spaza shops. The major problems that these businesses have in obtaining finance from banks are their limited availability of collateral and lack of information about their financial situation and solvency issues (this information is contained in a professional business plan).

The question arises … where do small businesses then obtain start-up funding? Most small businesses rely on their retained earnings (profits made if the concern is ongoing) or funding from friends and family for start-up capital. Figures indicate that about 80 per cent of SMEs in Africa provide funding themselves (or from family and friends), around 3 per cent through supplier credit and only 8 per cent through banks. Very small enterprises are mostly funded by government institutions such as SEDA (Small Enterprise Development Agency). South African banks focus more on medium and large businesses and large corporations.[4]

Financing microenterprises is largely left to state-run bodies and development finance initiatives, while the big five banks have begun to focus more on serving small and medium businesses.

Research done in 2017 indicates that 68 per cent of SMEs view economic instability as a primary challenge, while 38 per cent expressed concern about their cash flow. The South African small business community is concerned about the lack of support from government with 89 per cent of the SMEs interviewed feeling that the Department of Small Business Development does not provide the right support. This lack of support is felt in all aspects promised by government, with 48 per cent of entrepreneurs requiring additional funding, 44 per cent want less red tape, 43 per cent want more tax benefits, and 36 per cent want improved access to finance.[5]

3.3.4 The scope of the business plan: How much planning is needed?

The level of commitment to the writing of a business plan varies greatly among entrepreneurs. Should it be one page long or one hundred pages long? Considerations that determine the amount of planning include the following:

- the style and ability of the entrepreneur;
- the preferences of the management team;
- the complexity of the product or service and of the business;
- the competitive environment of the business; and
- the level of uncertainty in the business environment.

The depth and detail in the business plan therefore depend on the size and scope of the proposed new venture. An entrepreneur planning to market a new chicken fast-food franchise nationally will need a comprehensive business plan, largely because of the nature of the product and the market pursued. In contrast, an entrepreneur who wants to manufacture burglar bars and steel gates for the local market in a suburb or city will not need such a comprehensive plan. The difference in the scope of the business plan may depend on whether the new venture is a service, involves manufacturing, or is an industrial (business) product or consumer product. The size of the market, competition and many other environmental factors may also affect the scope of the business plan.

3.3.5 Components of the business plan

While it is important that the primary components of a solid business plan be outlined, every small entrepreneur must recognise that such a plan should be tailor-made, emphasising the particular strengths of the new venture. Two issues are of primary concern when preparing the business plan:

- The basic format of the written presentation; and
- The content or components of the business plan.

3.3.5.1 The format of the business plan

The first question that comes to mind when thinking about writing the business plan is: Who should write the plan? Many small-business managers employ the professional assistance of accountants, attorneys and business consultants. However, experts agree that the entrepreneur may consult professionals, but should, in the end, write the plan him- or herself. To help determine whether to use a consultant, the entrepreneur may use a table similar to Table 3.7 to make an objective assessment of his or her own skills.

Table 3.7: Skills assessment for writing a business plan

Through such an assessment, the entrepreneur can identify which skills are needed and who should be consulted to help prepare the business plan.

There are no rigid rules regarding the format of the business plan. However, whichever format is eventually decided on, the plan should have an attractive appearance.

The length of the business plan will depend on the venture, but it can vary from five to 20 pages, excluding annexures and substantiating documents.

3.3.5.2 The content of the business plan

As has already been mentioned, the business plan for each venture is unique. Although no single standard list of business-plan components exists, there is considerable agreement as to what the content of the business plan should be. The following are the most important components of the business plan:

- the executive summary;
- the general description of the venture;
- the products and services plan;
- the marketing plan;
- the management plan;
- the operating plan;
- the financial plan; and
- the supporting materials.

By now, it may be assumed that the value of a business plan is understood and the entrepreneur is ready to prepare one.

Apart from the fact that the business plan begins with the cover page, the huge amount of information that is available on the business makes it difficult to decide what to include under the headings of the various business plan components listed above. The beginner needs a conceptual scheme to identify the important segments of a good business plan. Table 3.8 provides an overview of such a plan.

Table 3.8: Overview of a business plan

Executive summary	A one- to three-page overview of the total business plan. Written after the other sections are highlights their significant points and, ideally, creates enough excitement to motivate the rea
General company description	Explains the type of company and gives its history if it already exists. Says whether it is a m retail, service or other type of business. Shows the type of legal organisation.

Products and services plan	Describes the product and/or service and points out any unique features. Explains why peo product or service.
Marketing plan	Shows who the business's customers will be and what type of competition the business will marketing strategy and specifies what will give the business a competitive edge.
Management plan	Identifies the 'key players': the active investors, management team and directors. Cites the competence they possess.
Operating plan	Explains the type of manufacturing or operating system the business will use. Describes the raw materials and processing requirements.
Financial plan	Specifies financial needs and contemplated sources of financing. Presents projections of re and profits.

Table 3.9 provides a more detailed outline for each section of a good business plan. Once the entrepreneur has completed each of these phases, he or she will have a simple but complete draft of a business plan. In developing a comprehensive plan, the simple plan will be supplemented by an exhaustive set of questions that should be considered. The examination and consideration of each component of the comprehensive business plan will be discussed in more detail in the sections that follow.

Table 3.9: Outline of a simple business plan

General company description	•Name and location •Nature and primary product or service of the business •Current status (start-up, buy-out or expansion) and history (if applicable •Legal form of organisation
Products and services plan	•Description of products and/or services •Superior features or advantages relative to competing products or serv •Any available legal protection, for example, patents, copyrights or trade •Dangers of technical or style obsolescence
Marketing plan	•Analysis of target market and profile of target customer •How customers will be identified and attracted •Selling approach, type of sales force and distribution channels •Types of sales promotion and advertising •Credit and pricing policies
Management plan	•Management team members and their qualifications •Other investors and/or directors and their qualifications •Outside resource people and their qualifications •Plans for recruiting and training employees
Operating plan	•Operating or manufacturing methods used to produce the product or se •Description of operating facilities (location, space and equipment) •Quality-control methods to be used •Procedures used to control inventory and operations •Sources of supply and purchasing procedures
Financial plan	•Revenue projections for three years •Expense projections for three years •Necessary financial resources •Sources of financing

3.3.6 Description of a new venture

The next step in the preparation of the business plan is a description of the venture. This step is an extension of the feasibility analysis discussed in Chapter 2. The entrepreneur analyses the business environment to assess the new idea or venture, the factors that might improve his or her chances of success and factors that could work negatively against the proposed venture. This analysis of the environment assists the entrepreneur in making a rational decision about whether to implement the idea or abandon it. If the entrepreneur decides to implement the idea, he or she must describe it in detail and prepare a business plan for the new idea or venture.

3.3.6.1 A general description of the new venture

Bearing in mind the needs and requirements of banks and investors for a successful business plan (that it should not be too long, and that it should be concise and accurate), a brief but accurate description of the new venture is necessary.

The body of the business plan begins with a brief description of the new venture itself. If the business is already in existence, its history is included. This section informs the reader, for example, whether the business is engaged in tourism, retailing, construction or some other line of business, and also where the business is located and whether it serves a local or an international market. In many cases, issues noted in the legal plan, especially the form of organisation, are incorporated into this section of the plan. Some important questions to be addressed in this section of the plan may include the following:

- Is this a start-up, buy-out or expansion?
- Has this business begun operations?
- What is the business's mission statement?
- Where was this business started?
- What is the basic nature and activity of the business?
- What is its primary product or service?
- Which customers are served?
- Is this business in manufacturing, retailing, service or another type of industry?
- What are the current and projected states of this industry?
- What is the business's stage of development? For example, has it begun operations? Is it producing a full product line?
- What are its objectives?
- What is the history of this company?
- Which achievements have been made to date?
- Which changes have been made in the structure or ownership of the existing business?
- What is the firm's distinctive competence?

Again, there are no fixed issues that should be considered in the general description of the new venture or existing business. Some entrepreneurs may emphasise a successful history, while others may concentrate on the new business's competitive advantage. The following general description of a business called Destiny Travel highlights four critical aspects that should be included in the general description.

CASE STUDY: Description of Destiny Travel

Name and location of the new venture

Destiny Travel is a proposed extension of a successful existing small venture called Tshwane Airport Shuttle. Tshwane Airport Shuttle has been operating for ten years, transferring mainly tourists from O.R. Tambo International Airport to Pretoria and back. It

now wants to expand into guided tours for tourists. Destiny Travel will be a partnership between James Madison and Jonathan Jansen. They can both be contacted at 444 Nicolson Street, Brooklyn, Pretoria, 0181, which is also the existing premises of Tshwane Airport Shuttle. Tel. 012 444 4444.

Nature and primary product or service of the business
During the past few years, the two partners have studied trends in the transfer and transportation of tourists, mainly in the Gauteng area of South Africa. They have identified a need of tourists for safe transfers, safe day trips and longer tours in a crime-ridden South Africa, where tourists have come to be included in robbery and murder statistics. Because of their previous experience in transferring tourists and business people from O.R. Tambo International Airport to Pretoria, offering guided transfers, trips and tours will form a natural extension of their existing small business. They expect to satisfy their customers by providing a safe and quality guided tour service in the upmarket segments of the tourism industry in Gauteng.

Current status
The new business, Destiny Travel, will start operating at the beginning of the new year, assuming that adequate funding can be found in the next four months.

Legal form of organisation
The new business will begin operation as a partnership between James Madison and Jonathan Jansen. Both partners agree to enter into a formal partnership agreement based on a 50/50 decision concerning workload, profits and responsibilities, and how the new venture is funded. Should the source of funding necessitate a limited company, the two persons also agree to restructure the legal form of the new venture to accommodate any requirements a bank or private investor may have.

Critical thinking

A business plan takes a lot of time and effort and is mostly done in conjunction with an outside expert providing assistance. Do you think that a business plan could really assist you to obtain a loan from a financial institution?

3.3.7 Analysing the market

Certain activities that form the basis of the business plan take place simultaneously. Strictly speaking, the description of the new venture's strategy can only be finalised once the entrepreneur has completed a market analysis to find out if a market for the product exists and, if so, how he or she will exploit the market. In other words, once the entrepreneur is convinced that there is good market potential in a particular segment of the market, he or she must work out how the product will reach the market and which marketing strategy to adopt.

Entrepreneurs often become infatuated with their product or service, and believe or hope that there is a market for it. This euphoria can be very costly, if not devastating, to the new venture with its limited resources. The analysis of the new venture's market and the development of a marketing strategy involves the following key items:

- Concepts;
- The identification of the target market/s;
- Research and forecasting in the target market; and
- A marketing plan or strategy for the selected market segment/s.

Chapter 13 deals with these aspects in detail.

3.3.8 Determining the financial needs of the new venture

The entrepreneur or potential investors need answers to certain crucial financial questions to determine whether the new venture is not only attractive, but also feasible. The financial analysis constitutes a further crucial component of the business plan. The entrepreneur's projections of a new venture's profits, its required assets and its financial requirements over the next one to five years should be supported by substantiated assumptions and explanations about how the costs, profits and financial requirements are determined. In order to make the necessary financial projections, the entrepreneur must first have a good understanding of financial statements and how to interpret them.

The key issues in this section are therefore:

- an understanding of how financial statements work;
- an understanding of how profitability is assessed; and
- an ability to determine a venture's financial requirements.

Chapter 14 deals with these aspects in detail.

3.4 The location of the business

3.4.1 The choice of location

The choice of geographical location for premises is of extreme importance for all kinds of businesses, although it may be more important for some businesses than for others. For certain businesses, location may be a crucial factor, for instance fast-food businesses. Depending on the nature of the proposed product or service to be offered, the entrepreneur should decide, for example, whether the business needs to be located near its market, near its sources of raw materials, near to other competitors, in the city centre, in the suburbs, in a rural area, in existing industrial areas or according to other personal preferences.

The **location factors** that have to be considered when making this choice are briefly analysed in section 3.4.2.

3.4.2 Location factors

The most important location factors are the following:

- **Sources of raw materials.** Where, in which quantity, of which quality and at which prices can these materials be obtained? This is especially important for a company such as Eskom that needs to be near to its coal mines as a major source of raw materials.
- **Availability of labour.** Where and at which cost is the required labour available in terms of, for example, quantities, levels of training, development potential and productivity? This is important to South African automobile manufacturers, for example, which are labour intensive but require skilled workers to operate specialised assembly machines.
- **Proximity and access to the market.** This includes aspects such as the potential advantages over present competitors, the current extent and potential development of the market, the perishability of products, the needs of consumers and users regarding, for example, delivery, after-sales services and personal contact, and the possible entry of competitors into the market.
- **Availability and cost of transport facilities.** This includes aspects such as the availability of rail, air and road transport; pipeline and water transport facilities; the transport costs of raw materials in relation to finished products; and the possibility of the entrepreneur using his or her own transport (road links and limitations of

private transport). The accessibility to Transnet facilities (rail haulage) could be a major factor for farmers delivering maize, for example.

- **Availability and costs of power and water.** These must satisfy the needs of the prospective business. We all understand the problems that South African businesses encounter during load shedding.
- **Availability and costs of a site and buildings.** Buildings need to comprise units of the required size and appearance, with the necessary facilities and expansion possibilities. Consideration should also be given to accessibility for suppliers of raw materials, customers and employees.
- **Availability of capital.** This does not necessarily affect the choice of a specific location, but can still play a role when the suppliers of capital set specific conditions or express certain preferences in this regard, for example, or when capital is such a limiting factor that it necessitates the choice of the cheapest location.
- **Attitude, regulations and tariffs of local authorities.** These comprise, for example, the attitude of local authorities to industrial development, including possible concessions that encourage location, health regulations, building regulations, property rates, water and electricity tariffs, and the availability and costs of other municipal services.
- **The existing business environment.** This could influence the establishment of the proposed business by, for example, the provision of repair and maintenance services, as well as the availability of spares, and banking, postal and other communication facilities.
- **The social environment.** This concerns the provision of satisfactory housing and educational, medical, recreational and shopping facilities for employees of the proposed business.
- **Climate.** Some production processes require a particular type of climate. Climate can also influence the acquisition, retention and productivity of personnel.
- **Central government policy.** This may encourage or discourage the establishment of certain types of business in specific areas in a direct or indirect manner through, for example, tax concessions.
- **Personal preferences.** These relate to the area or areas in which entrepreneurs and their families prefer to live.

Critical thinking

In business there is an old saying that the key to the success of a business lies in three words, namely 'location, location and location.' Do you always have to agree with this statement?

3.5 Summary

In this chapter, the legal forms of a business that are available to the entrepreneur were discussed. This discussion covered the characteristics, advantages and disadvantages of the sole proprietorship, the partnership, the close corporation, the company, the business trust and co-operative societies. In addition, the development of the business plan for a new venture was examined. The final section of the chapter dealt with the most important location factors that the business must consider.

Small business perspective

The SME realities in South Africa (circa 2018)

Globally, small businesses are seen as the main generator of jobs, and a major contributor to the GDP of the economies of countries. The South African government has a National Development Plan (NDP), of which one of the objectives is that small businesses should create 90 per cent of jobs in the economy by 2030. This objective has been questioned in recent research with regard to the current size of the small business sector. This research by the Small Business Institute (SBI), in partnership with the Small Business Project (SBP), debunks previous research that estimated the number of SMMEs in South Africa at 5,6 million. The previous research stated that the greatest majority (3,3 million) of small businesses were 'survivalist businesses' with another 1,7 million micro-enterprises and only 554 000 small enterprises. The new research estimates that South Africa has only 250 000 formal small-, medium- and micro-sized enterprises (SMMEs), which is much less than the previous survey estimation.

One of the implications of the new research is that the estimated size of South Africa's small business segment is not in line with common guidelines regarding SME contribution to the GDP, employment absorption and contribution to the tax base of the country. As a baseline, it is reported that in OECD countries more than 95 per cent of businesses are defined as SMEs, creating between 60–70 per cent of employment opportunities and contributing up to 60 per cent to the GDP of these countries. In comparison, recent research now indicates that the South African SMEs makes up 98,5 per cent of all businesses but employ only 28 per cent of employees in the country

What is of further interest is that the largest 1000 businesses are the greatest employers of people in South Africa, generating as many as 56 per cent of jobs in South Africa with central government one of the largest employers in the country. A problem identified in the recent research, is that government and its agencies, which are tasked to support and grow SMEs, do not use a universal definition of what a small, very small or medium business entails in the application of the laws, regulations and key strategies to grow SMEs in South Africa. The confusion of what a SME entails is reflected across 70 existing laws, regulations and strategies. This confusion facilitates red tape, confusion and barriers to start, run and grow SMEs in South Africa. This is despite the creation of the Ministry of Small Business Development and the Department of Small Business Development to enhance the future of SMEs in the country.

KEY TERMS	
business plan	limited liability
business trust	location factor
close corporation	Memorandum of Incorporation
co-operative society	Notice of Incorporation
company	partnership
joint venture	perpetual existence
legal or juristic personality	sole proprietorship

Questions for discussion

1. Why is the correct legal entity of a small business so important?

2.What are the advantages and disadvantages of a business trust?

3.Assume that you are a female entrepreneur who is married to an up-and-coming businessman who owns two business properties in the CBD of Johannesburg. The couple also owns a house, which is registered in the husband's name. What are the tax implications of this arrangement when the male entrepreneur's businesses run into trouble?

4.Why is a business plan important? Consider this question from the perspectives of both internal and external users.

5.What are the key sections of a business plan?

6.What are the factors to consider when deciding on the location of a small car washing business?

Multiple-choice questions

1.The business format selected by the entrepreneur has a lot to do with the legal personality of the business. How many of the following descriptions of a legal personality is/are correct?

i.The business as a legal person exists independently from its members.
ii.It is perceived by the law that a legal person is similar to a natural person.
iii.A legal personality has its own assets and obligations, such as the repayment of loans.
iv.The business's existence is affected by changes in the number of people who are members of the business.

a.One
b.Two
c.Three
d.Four

2.How many of the following are benefits of a business plan?

i.A business plan is a realistic evaluation of the business's chances of success in the marketplace.
ii.It provides a summary of the key aspects that will determine the success as well as the main risks of the business.
iii.It is a control instrument to compare results against targeted performance.
iv.It is an important instrument to attract capital to finance the business.

a.One
b.Two
c.Three
d.Four

3.How many of the following are reasons for an entrepreneur to write a business plan?

i.To obtain bank financing
ii.To arrange strategic alliances
iii.To obtain investment funds
iv.To complete mergers and acquisitions

a.i

b.i, ii
c.i, ii, iii
d.i, ii, iii, iv

4.What do banks use to evaluate a loan application?
i.Capital and collateral
ii.Capital, collateral, and conditions
iii.Capital, collateral, character, and conditions
iv.Collateral and character
a.One
b.Two
c.Three
d.Four

5.How many of the following are important location factors?
i.Proximity and access to the market.
ii.Availability of labour
iii.Central government policy
iv.Social environment
a.i
b.i, ii
c.i, ii, iii
d.i, ii, iii, iv

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CHAPTER 4

The business environment

Johan Strydom

The purpose of this chapter

This chapter introduces the environment in which a business functions and explains how the environment influences the development of a business organisation. This includes treatment of the following related topics:

- Understanding environmental change;
- The composition and characteristics of the business environment model;
- The impact of the different environmental variables (the components of the sub-environments) on the daily operation of a business;
- Threats and opportunities that transpire due to the interaction of the variables in the external environment;
- Why the business environment must be monitored; and
- How a business organisation can respond to changes in the environment.

These topics are illustrated by the De Beers case study on page 123. Both entrepreneurs and established organisations must consider the internal and external environmental factors that can help or hinder the development of their business. These environmental factors are the fundamental foundation of the strategies implemented by the organisation.[1] This chapter discusses various kinds of strategies that a business can use in the changing environment.

Learning outcomes

On completion of this chapter you should be able to:

- understand the meaning of environmental change
- explain the composition and characteristics of the business environmental model
- discuss each of the sub-environments of the environmental model
- explain how each of the environmental variables in the micro-, market and macroenvironments can influence an industry or individual business
- explain the difference between opportunities and threats in the external environment
- discuss environmental scanning as a means of managing change in the business environment.

4.1 Introduction

Society depends on **business** organisations for most of the products and services it needs, including the employment opportunities that businesses create. Conversely, business organisations are not self-sufficient, nor are they autonomous. They obtain resources from the society and environment in which they operate. Therefore, business organisations and society (or, more specifically, the environment in which the businesses function) are mutually dependent.

This mutual dependence entails a complex relationship between business organisations and their environment. This relationship increases in complexity when certain variables in the environment (such as technological innovation or political developments) bring about constant change that impacts the business organisation in different ways.

The importance and influence of **environmental change** on the successful management of an organisation has become acutely apparent in the last few decades when environmental forces brought about unforeseen change. The process began with technological innovations that are today named Industry 1.0 and Industry 2.0 (the first was the era of mechanisation where water and steam played an important role, and the second, new technological systems using superior electrical technology. This led to the industrialisation era of manufacturing factories and mass production, as evidenced by motor companies like Ford Motor Company). We have subsequently seen extreme spikes in energy- and oil-prices, resulting in worldwide inflation and a decline in the global economy. In the 1980s, there was a shift from local to global business (the globalisation process), and many countries experienced fierce competition from Japan and other Asian countries. The 1990s heralded a new age of connectivity, with the emergence of the Internet and the World Wide Web, both of which revolutionised the operations of business organisations. Businesses could now send their digital material anywhere at very little cost. The spread of the commercial web browser allowed individuals and companies to retrieve documents or web pages stored in websites and display them on any computer screen in an easy-to-use manner.[2] This heralded the advent of the Third Industrial Revolution (called Industry 3.0). The era of Industry 4.0 (Fourth Industrial Revolution) followed hereafter. The Fourth Industrial Revolution is based on smart machines using, *inter alia*, storage and manufacturing facilities that communicate information in real time without the intervention of humans. Some of the key elements of Industry 4.0 include the Internet of Things (IoT) and Cloud computing. Currently there is a debate as to whether Industry 5.0 is imminent, with humans working in close harmony with machines (computers) to improve efficiencies and productivity in the workplace.

In the global economy the latter part of the 1990s was characterised in Western countries by the longest-ever economic boom, which ended on 11 September 2001 with the attack on the World Trade Center in New York. This incident heralded a new era in world history, introducing a new world order with new alliances and new enemies. In 2008, the stock market crash on New York's Wall Street signalled the start of a global financial crisis, which led to economic recession in many countries. This crisis impacted on the world economy and its after-effects are still being felt in various countries, such as South Africa.

Coupled with this are the effects of world disunity on the political front with problems in the Middle East and Russia, issues of migration globally, Brexit, and perennial problems of political instability in Africa. Furthermore, the stagnating global economy led to problems in Europe (called the European sovereign debt crisis) with Spain, Italy and especially Portugal and Greece feeling the effects of the global recession. Many of these European countries are in a poor financial position and unable to repay or refinance their government debt. They are also not in a position to help their over-indebted banks and are dependent on the assistance of third parties such as the European Central Bank and the IMF to alleviate their financial problems. Obviously South Africa was also influenced by these problems, as Europe is one of South Africa's main trading partners.

After experiencing many years of macroeconomic stability and a global commodities boom, South Africa was not exempt from the worldwide crisis. The economy began to slow in the second half of 2008 owing to decreased demand and commodity prices.[3] South Africa officially entered an economic recession in the first half of 2009, ending one of the longest growth cycles in the South African economy. The South

African economy has just emerged from what is called a 'technical recession', but is faced by slow growth which does not bode well for growth and employment opportunities in the country in the near future.

During the period 2008 to 2012 the South African economy grew, on average, by just 2 per cent, and it would seem that this growth rate will not improve in the immediate future. By 2014 South Africa's GDP grew by just 1,5 per cent, while it struggled to reach 1 per cent growth per year in 2018.[4]

These global events and South Africa's own political and cultural changes have all combined to make the South African business environment more challenging. Key infrastructural issues, such as the regular supply of basic commodities like electricity and water, are affecting the competitive business environment in which South African businesses operate.[5]

The previous decades of instability and the new era of rapid change and uncertainty have increased business organisations' need to try to deal with the impact of environmental change. The result of this is a greater awareness of environmental influences on management decisions, and the development of an approach to investigate and monitor change in the environment, which is encapsulated in the environmental business model discussed in this chapter.

4.2 The business and environmental change

It has been said that change is a fundamental characteristic of our time and that it is the only definite phenomenon in the management of a business.[6]

In the management sciences particularly, change is a difficult concept to define. The *South African Pocket Oxford Dictionary* defines change as 'moving from one system or situation to another'.[7] Expressed simply, change refers to any alteration in the status quo. This implies a change from a condition of stability to one of instability, a shift from the predictable to the unpredictable or from the known to the unknown. Change cannot be measured or controlled, and it causes insecurity. No single factor can be held responsible for it, and it occurs in different ways and at different rates depending on the place and community in which it occurs. Moreover, the rate of change often has a greater effect on the business environment than the direction of change, which could possibly have been occurring for a number of years in any case.

In the second decade of the 21st century, the rapid rate of change is even more staggering. Today the rise of a knowledge economy is characterised by an explosion of new technologies – which, in its own right, is disruptive to the existing technologies of a country. The introduction of social media such as Facebook and Twitter has opened a world of knowledge and resources, connecting people all over the world. Supercomputers, email, fibre-optic networks, teleconferencing and connection software such as Skype allow more people than ever before to collaborate and compete in real time with other people on different kinds of projects from different corners of the planet and on a more equal footing than at any previous time in history. All these changes are combined in what is previously explained as part of the Fourth Industrial Revolution (Industry 4.0).[8]

Figure 4.1 shows the three sub-environments of the business environment. Environmental variables (the components of each sub-environment) increasingly affect the environment in which business organisations operate and make decisions regarding investments and strategies very demanding.

Figure 4.1: The business environment

Environmental variables that are constantly changing the environment in which business organisations operate include technological innovations (such as e-commerce, digital marketing, secure online-payment systems and Artificial Intelligence (AI)), economic fluctuations (such as changes in the exchange rate and interest rate), legislation (such as South Africa's labour laws regarding fixed-term contracts, discussed in more detail in Chapter 12) and social factors (such as increased urbanisation and changing social values such as taking care of retired people). During the past 26 years, the structure of South African society and its lifestyles, values and expectations have changed visibly, in particular since 27 April 1994, when a democratic South Africa was formally established.

South Africa's government brought about drastic changes – in particular, a new social order and an economy based on socialistic principles. The democratisation of South Africa also normalised the country's international relations, but at the same time exposed South African businesses to the borderless world in which they have to compete. Another notable transformation was the initial steady economic growth that was achieved during the first two decades of democracy.

However, by 2015 the South African economy was in the doldrums, with an increasing debt burden that is threatening the economic survival of the South African economy.

The South African economy is severely affected by declining investment in the mining sector as well as in the industrial and engineering sectors. One of the few highlights is the South African motor industry which has been a star performer in exporting automobiles to Europe. Supply-side logjams such as electricity supply interruptions provide an uncertain economic climate with failing infrastructure, such as water reticulation and sanitation, impacting on the quality of life of South Africans.

In addition, South Africa is experiencing accelerating urbanisation, increased poverty, an influx of skilled and unskilled immigrants, xenophobia and high crime rates, all of which are affecting the South African business environment and eroding business confidence in the country.

The following case study looks at De Beers, a big player in the South African business environment. It shows how De Beers has experienced radical changes in the 130 years of its existence, both in South Africa where it started out and in the rest of the world where it is operating at present.

Worldwide, business organisations are restructuring, outsourcing and trimming workforces. Without these major changes, business organisations would not be able to align themselves with the realities of the changing external environment. If business organisations do not adapt to these changes, they would not be fit to compete in the new global economy.

Other changes that affect the business organisation include changes in monetary and fiscal policy, which impact on financial management. Changing consumer needs, often the result of economic and technological change, make new demands on marketing management. Existing methods of operation can change suddenly because of technological advances, and the introduction of new raw materials can cause established industries to change or disappear completely. Moreover, trade unions – through strikes and forced absenteeism – are making increasing demands on the

management of human resources. All of these changes are reflected in the De Beers case study.

The interaction between the environment and a business organisation is an ongoing process that often results in a new environment with new **threats** and new **opportunities**. Management should align its organisation with the environment in which it operates in such a way that it can identify, in advance, the opportunities and threats that environmental change brings. It is only when management is fully prepared that an organisation can fully utilise opportunities and deal with possible threats. To be able to do this, managers must first understand the composition and nature of the business environment.

CASE STUDY: How the business environment is influencing De Beers

De Beers was established in 1888 as a joint venture between Cecil John Rhodes and Barney Barnato, who was instrumental in the development of the South African diamond industry. Sir Ernest Oppenheimer started the Anglo American Corporation in 1917 to develop the gold mining industry in South Africa. In 1926 he was elected to the De Beers board after Anglo American Corporation became a major shareholder in De Beers. Two generations of Oppenheimers followed suit to manage the business to become one of the world's biggest diamond suppliers with a monopoly on the extraction and selling of diamonds. In 2012 Anglo American bought out the Oppenheimer family's share of De Beers, making it the majority shareholder with the remaining shares being held by the Botswana government. Today De Beers is an international corporation with a diverse portfolio which can be seen as a vertical integration process. It focusses on diamond exploration (finding new sources of diamonds), diamond extraction through the mining of diamonds in various parts of the world through open-pit mining, finding alluvial diamonds in coastal waters, and through deep sea extraction, the trading of diamonds on wholesale level, the selling of diamonds through its own and other diamond retail outlets, as well as manufacturing industrial diamonds for industrial use. De Beers remains one of the leading diamond companies in the world, with a diversified portfolio of mines in different parts of the world. In South Africa the Venetia open-pit mine near Mussina is one of the prime suppliers of diamonds in South Africa. This open-pit mine will also, in future, delve deeper, developing an underground mine below the Venetia open pit area. In Botswana, De Beers has four open pit mines, namely Jwaneng, Orapa, Letlhakane and Damtshaa. The De Beers group is also active in Namibia, mining on land and at the Orange River mouth as well as in the Atlantic around this area. The group also has a diamond mine at Gahcho Kué in Canada in a joint venture with the local mining group Mountain Province Diamonds.

In its early years, when the company produced over 90 per cent of the world's diamonds, it was able to control the production and hence the supply of diamonds almost at will (a typical monopoly situation). Then, from the early 1900s – when competitors began to challenge its prominence in the supply chain of diamonds – De Beers used its position to co-ordinate and regulate the supply of diamonds in pursuit of price stability and consumer confidence. Today, this could be interpreted as price-fixing and setting up a cartel. During the 1990s, the diamond industry experienced dramatic swings in the supply of diamonds, the world economy moved onto a low inflationary path and the industry experienced a period of pricing pressure, causing De Beers to rethink its business model and strategy regarding the supply of diamonds.

Today, De Beers is 130-years-old and has adapted to various changes through the years. It has seen through two world wars and changes in government in various countries. Its longevity is a reflection of its ability to adapt to changing situations, a long-term approach that is needed to be successful in the diamond business, and a sophisticated approach to sustainability that lies at the heart of its business model.

There is, however, concern over the long-term supply of diamonds with exploration finding it more difficult to identify major new diamond deposits. Well-known De Beers mines

such as Cullinan and Finsch and the diamond mines in Namaqualand have also been sold off, limiting its access to new diamonds sources.

However, De Beers has achieved much in recent years by reshaping the business, *inter alia*, through diversifying its mining operations to all parts of the world, seeking cost and capital efficiencies, and driving profitability. Tough decisions made in the good times helped De Beers to prepare its portfolio for the less favourable trading conditions that it has encountered in the past number of years. The company sees future opportunities downstream in the value chain by extending its high-end jewellery stores: De Beers has a 50 per cent joint venture with luxury goods company Louis Vuitton Moët Hennessy (LVMH), which has 70 prestigious houses or brands such as Hermes, Bulgari, Dom Perignon, Glenmorangie, Guerlain and Givenchy. These brands are grouped into five different sectors: wines and spirits; fashion and leather goods; perfumes and cosmetics; watches and jewellery; and selective retailing. All of this indicates that De Beers has evolved from being a producer of rough diamonds to being a retailer selling final products to well-off customers in diverse countries ranging from the USA, the UK, Europe and new upcoming world consumption economies such as China and India.

Sources: Robinson, T. 2004. The double-decker diamond mine. *South African Process Engineer*, No. 6. Cape Town: Johnnic Communications, p. 36; De Beers. 2008. *Report to Society 2008. Living up to diamonds: From natural resources to shared national wealth*. Available at http://www.debeersgroup.com/ImageVault/Images/id_1847/ImageVaultHandler.aspx. [Accessed 11 February 2010]; De Beers. 2008. *Operating and financial review 2008*. Available at http://www.debeersgroup.com/ImageVault/Images/id_1709/ImageVaultHandler.aspx. [Accessed 11 February 2010]; De Beers. 2012. *Operating and financial review 2012*. Available at http://www.debeersgroup.com/ImageVaultFiles/id_1703/cf_5/_De_Beers_Operating_and_Financial_Review_2011.PDF; De Beers. 2014. De Beers Analyst Seminar. Available at http://www.angloamerican.com/~/media/Files/A/Anglo-American-Plc/investors/presentations/2014pres/de-beers-seminar-london-nov-2014.pdf. [Accessed 9 March 2015]; Mathews, C. 2012. Diamond De Beers. *Financial Mail* 216(10): 44; Mathews, C. 2015. Diamonds: Affordable luxury. Available at http://www.financialmail.co.za/moneyinvesting/2015/01/22/diamonds-affordable-luxury. [Accessed 9 March 2015].

Critical thinking

It is crucial for businesses to pay careful attention to the constant changes in the business environment and to react to these changes. This is especially true for global corporations operating in South Africa. These corporations have a social contract with various stakeholders in South Africa with a specific focus on job creation and the contribution of these corporations to the South African economy. The South African motor industry is a star performer, creating many job opportunities. There is, however, an increasing demand for more highly skilled workers which puts new demands on the secondary and tertiary education system. The question is: are there enough sufficiently qualified people to do these jobs?

4.3 The composition of the business environment

In the latter half of the 20th century, it became very clear that the effective management of the business organisation required management to take careful note of environmental changes in order to develop new business strategies.

This was partly the result of the systems approach to management, which argued that an organisation is an integral part of its environment and that management should therefore adopt a policy of 'organisational Darwinism' to ensure that its business does not become extinct in a rapidly changing world in which only the fittest can survive.

The rising instability in the environment has made it increasingly necessary to study environmental change and influences. But the question was what exactly to look for in the environment. It would have been hopelessly confusing to have to take every single factor into consideration without any framework to organise information. A variety of influences, ranging from spiritual and cultural values to purely natural influences, may be identified as determinant variables in the business environment.[9]

The **business environment** is therefore defined as all the factors or variables, both inside as well as outside the business organisation, that may influence the continued and successful existence of the business organisation. In other words, the business environment refers to the internal as well as the external factors that impact on the business organisation, and that largely determine its success.

4.3.1 The three subenvironments

In order to recognise the environmental variables that influence a business, a realistic environmental model must be established. This is necessary for classifying the different variables in the business environment. Classification makes it possible to identify distinct trends per sub-category of the business environment, which enables further analysis of these trends.

Figure 4.2 on page 127 shows the composition of the business environment (also called the business environmental model) with its various sub-environments. It is a visual model of the interaction between a business organisation and its environment. According to this model, the business environment consists of the three distinct sub-environments described in the sections that follow.

4.3.1.1 The micro-environment

The **micro-environment** consists of the business itself, over which management has complete control. This includes variables in this environment, such as the **vision**, mission and objectives of the business organisation, the various **business functions** and the **resources** and strategies of the business, which are under the direct control of management. The decisions made by management will influence the market environment through the strategy employed to protect, maintain or increase the business's share of the market. For example, management might apply a marketing strategy using unique products and services and effective marketing communication activities to increase market share.

An analysis of the micro-environment allows managers to determine the capabilities, and the strengths and weaknesses of the organisation.[10] (A strength is described as an aspect of a business that provides it with an advantage in its business environment, while a weakness is a limitation of the business that places it at a disadvantage). Knowing the organisation's strengths and weaknesses puts management in a position to use available opportunities better and to identify and counter threats to the business, ensuring that it remains a stable entity.

The micro-environments of many business organisations worldwide have been subjected to changes relating to re-engineering, restructuring and trimming workforces. Without these major changes, businesses would no longer be able to align themselves with a changing environment.

4.3.1.2 The market environment

The **market environment** is encountered immediately outside the business organisation (see Figure 4.1 on page 122). In this environment, all the variables depicted in Figure 4.2 become relevant for every organisation, because they determine

the nature and strength of competition in any industry. The key variables in this environment are the following:

- **Consumers** or customers with a particular buying power and behaviour who buy the products and services of the business stand central to the business as their reason for existence;
- **Competitors**, including new and potential competitors who want to maintain or improve their market-share in the marketplace;
- The **labour market and labour unions**. Aspects such as the availability of skilled labour and the impact of strikes on business are well-known variables in South Africa and may result in the business failing and must thus be considered by the businesses;
- **Intermediaries**, who compete with each other to handle (distribute) the business's product to get it to the consumer; and
- **Suppliers**, who supply, or do not wish to supply, raw materials, products, services and finance to the business organisation to enable it to manufacture the products and services that the consumer requires.

All of these variables give rise to particular opportunities and threats. It is in the market environment that management finds its most important tasks: to identify, assess and take advantage of opportunities and threats in the marketplace, and to develop and adapt its strategies to meet competition. For these reasons, the market environment is often called the task environment, in which top managements' main task must be to note changes and anticipate their impact on the business.

Management has no control over the components of the market environment, although management may influence the relevant variables through its strategy. However, the market environment continually influences a business, and the business must adapt to these changes.

Figure 4.2: The composition of the business environment

For example, a new competitor with sufficient resources could start a price war, or a competitor could market a new product protected by patents. In the case study on De Beers, it was noted that De Beers is very aware of the limited supply of rough diamonds and has moved downstream in the value chain (retail jewellery stores) to boost turnover. In a most recent development, De Beers has started to manufacture synthetic diamonds due to the pressure of competitors who have entered the market selling these industrial diamonds. Conditions such as consumer buying power and consumer boycotts can also affect a business. (The fictional movie *Blood Diamond* reflects an increased consumer awareness of the unethical trading of diamonds sourced from war-torn countries, hence the title of the movie). Changes have been made to the distribution system where the origin of diamonds is tracked and certified. De Beers started to use block chain technology in 2018 to allow them to trace each diamond throughout the entire value chain, that is, from the place of extraction to the final buyer to ensure that it is not associated with illegal diamond trading.[11]

Both the market environment and the micro-environment are affected by developments in the macroenvironment (also called the far-off or external environment).

4.3.1.3 The macro-environment

The **macro-environment** is the sub-environment that is external to both the organisation and the market environment. Threats and opportunities may occur in the macro-environment, but, as the individual business organisation has little or no control over the macro-environment, its influence on these threats and opportunities is insignificant. A threat can be described as an external variable in the business environment that could cause harm to the business; an opportunity is the opposite, namely a chance to generate more market share, turnover or profits for the business.

The macro-environment consists of six distinct components or variables:

- The **technological environment**, which continuously brings change and innovation to the business world;
- The **economic environment**, in which factors such as inflation, exchange rates, recessions and monetary and fiscal policy influence the prosperity of the business organisation;
- The **social environment**, in which consumer lifestyles, habits and values (formed by culture) make certain demands on the business organisation, particularly through consumerism;
- The **physical environment**, which consists of natural resources such as mineral wealth, flora and fauna, and manufactured infrastructural improvements such as electricity supply, sanitation and roads and bridges. This is the environment in which the business operates and where it must show responsibility towards society by operating in a carbon-positive, or at least a carbon-neutral way in its interaction with the environment.;
- The **institutional environment**, with the government and its political and legislative involvement as the main components. By means of legislation, for instance, governments influence business; and
- The **international environment**, in which local and foreign political and social trends and events affect the business organisation (micro-environment) as well as the market environment.

Just as there is interplay between the three sub-environments, there is interplay between the variables peculiar to each sub-environment (for example, the interplay between the technological and social environments). These interactions will be elaborated on in sections 4.4 to 4.6.

4.3.2 Characteristics of the business environment

The most important characteristics of the business environment are the interrelatedness of the environmental variables, the increasing instability, the environmental uncertainty and the complexity of the environment. A discussion of each of these will show why it is necessary for management to monitor these characteristics continuously.

- **The interrelatedness of environmental factors** or variables means that a change in one of the external factors may cause a change in the micro-environment and, similarly, a change in one external factor may cause a change in the other external factors. For example, the period since 2008 has seen a slowing of the economy in South Africa with tepid growth and a general decline in the performance of the Johannesburg Stock Exchange (JSE) – Africa's largest securities exchange – and a resultant decline in the value of the rand against the major foreign trading currencies. This, in turn, has resulted in more economic change, including job losses and a very low labour absorption rate with thousands of young people finding it extremely difficult to gain entry to the labour market.

- **Increasing instability and change** comprise one of the consequences of interdependence in the environment and is mostly driven by innovation. However, although the general rate of change in the environment accelerates, environmental fluctuation is greater for some industries than for others. For example, the rate of change in the pharmaceutical and electronics industries may be higher than in the automobile-component and bakery industries.
- **Environmental uncertainty** is dependent on the amount of information that management has about environmental variables, and on the confidence that management has in such information. If there is little information available, or if the value of the information is suspect, management's uncertainty about the environment will increase.
- **The complexity of the environment** indicates the number of external variables to which a business organisation has to respond, as well as variations in the variables themselves. A bakery, for example, has fewer variables to consider in its business environment than a global manufacturer of computers, and therefore has a less complex environment. It is one of the advantages of businesses with less complex environments that they need less environmental information to make decisions.

These few exceptional characteristics of the environment show how important it is for management to know and understand the environment within which the business organisation operates.

Critical thinking

Business organisations should be proactive in continuously monitoring the many variables that may influence the state of the business environment in which they operate. New investment opportunities are based on the monitoring of these variables. This monitoring process also forms the foundation of strategy formulation for the business. By doing this, organisations minimise the risk of being caught off guard and maximise their ability to deal effectively with challenges. Do you think this kind of monitoring is really done by businesses in South Africa?

The intricacy of the business environment: Inflation illustrated

In considering the characteristics of the business environment, the economic variable of inflation is a good example to illustrate the interrelatedness, uncertainty, instability and complexity of the business environment. What are the various environmental variables that might influence inflation in South Africa?

- **The physical environment**. Aspects such as rainfall and climate have an influence on the inflation rate. Droughts could influence the production of maize which will have a knock-on effect on the price of animal feed and eventually increase the price of beef, for example. Obviously, this will impact on the food inflation rate for South African consumers.
- **Consumer buying power**. An increase in consumer spending is a result of, among other things, economic growth, low interest rates and the growth of the middle class. Conversely, a decrease in consumer spending is a result of slower economic growth and higher interest rates, and therefore a slower growth of previously high-potential markets.
- **The international environment**. The rise in the crude-oil price affects the price of fuel. This then causes increases in the price of food and other basic commodities. Further aspects, such as wars and piracy in the shipping lanes around the Horn of Africa, are also affecting businesses indirectly by increasing the cost of crude oil transportation.
- **The economic environment**. A depreciation of the rand's exchange rate, interest-rate hikes and a high unemployment rate are contributing factors to a poorer economy, which impacts on the inflation rate and affects all citizens of South Africa.

All of the variables listed above are likely to lead to acceleration in inflation in the short term.

4.4 The micro-environment

As explained earlier, the micro-environment comprises the internal environment of the business. The micro-environment may be viewed as an environment with three sets of variables:

- The business's vision, mission, strategies and objectives;
- The business's management and organisational functions; and
- The business's resources.[12]

These variables are instrumental in delivering the outputs of the business, and they are under the direct control of management. An analysis of these variables will lead to the identification of the organisation's strengths and weaknesses, which forms part of the environmental analysis (see Section 4.7). Each of the variables in the micro-environment is linked to the external environment in some way.

The vision, mission, strategies and objectives of the enterprise are the reason for its existence. A **vision statement** answers the question: What do we want to become? A **mission statement** is developed after the vision statement and answers the question: What is our business? This question was first asked by Peter Drucker, who is viewed as the father of modern management. A mission statement 'can be described as the reason why an organisation is in business and is used to distinguish one business from other similar firms'.[13] The mission statement serves as the foundation for the development of long-term objectives, which are the specific results an organisation seeks to achieve. These objectives must be further developed into strategies such as how to grow the market share of the business. This may include developing new products or services. (Without specific objectives to strive for and strategies to implement, there would be no need for an organisation.) Examples of vision and mission statements of two fairly similar businesses that operate in the field of logistics are given below. The South African Post Office operates in South Africa (currently a poor performing business) and DHL is a logistics company operating in more than 220 countries in the world.

Comparison of the mission and vision of the Post Office versus DHL

Post Office. Vision: 'A leading provider of postal, logistics and financial services to the South African market.' Mission: 'We leverage our established infrastructure and link government, business and customers with each other locally and abroad.'[14]

DHL. Vision: 'The Logistics Company for the World.' Mission: 'Excellence, Simply delivered.'[15]

An organisation's vision and mission statements, such as those given above, are influenced by the external environment. For example, if there is a drastic decrease in the demand for the South African Post Office's services owing to changes in South African consumer preferences for using the Post Office's value propositions (services), it would force the Post Office to reconsider its stated vision and mission. If this decline in the demand for services turned out to be a prolonged social trend, the organisation might need to reconsider its reason for existence.

The different areas of management or business functions and the way in which an organisation is structured constitute another set of variables in the micro-environment, which has certain interfaces with the external environment. For example, marketing is the business function that is in close contact with the market: marketing management keeps an eye on consumers and their preferences as well as on the activities of competitors so that it can develop strategies to counter any influences from the market

environment. Similarly, financial management keeps an eye on levels of taxation and rates of interest that could influence the financial position of the business. Human resources management may influence the environment through its employment policy, just as trade unions, strikes, the availability of skilled labour, wage demands and new labour laws may affect its decisions from outside the business. A business should be structured in such a way that it is able to deal with influences from the environment and still operate productively within the environment – especially the market environment, which is discussed in Section 4.5.

The resources of a business comprise the last set of internal variables that have certain interfaces with external environments. These resources include the following:

- **Tangible resources**, such as production facilities (e.g. machines), raw materials, financial resources, property and computers;
- **Intangible resources**, such as brand names, patents and trademarks, the company reputation, technical knowledge, organisational morale and accumulated experience; and
- **Organisational capabilities**, which refer to the ability to combine resources, people and processes in particular ways.

The resources of a business organisation can be at risk from threats or they can benefit from opportunities presented by external environmental variables. For example, an important tangible resource such as a particular production process may be threatened by a new technology or a new invention. Alternatively, special skills or knowledge (an intangible resource) can be employed to exploit an opportunity in the environment, such as when a business with knowledge and experience of exporting takes advantage of a devaluation in the rand to make increased profits.

This also illustrates that while some business organisations are threatened by a specific variable in the external environment, the variable may appear to be an opportunity for other organisations. Furthermore, this shows that the micro-environment varies from one business organisation to the next.

4.5 The market environment

The market environment (or task environment) is immediately outside the business organisation, as shown in Figures 4.1 and 4.2. It consists of the market (customers, the labour market and labour unions), suppliers, intermediaries and competitors, which are sources of both opportunities for, and threats to, a business. More precisely, this environment contains the variables that revolve around competition. To understand clearly the interaction between the enterprise and its market environment, it is necessary to examine the variables in the market environment more closely.

4.5.1 The market

Several meanings can be attached to the term ‘market’, but in this context, it refers to people who have needs to satisfy and the financial means to do so. In other words, the market, as a variable in the market environment, consists of people with particular demands who manifest certain forms of behaviour in satisfying those demands. (The market is discussed more fully in Chapter 13 as part of the discussion of the marketing function.) If a business wants to achieve success with a strategy of influencing consumer decisions in its favour in a competitive environment, management needs to be fully informed about all aspects of consumer needs, purchasing power and buying behaviour.

Management also has to understand that the conditions in the customer marketplace are directly influenced by variables in the macro-environment:

demographic trends may influence the number of consumers, economic factors such as high interest rates determine the available buying power of consumers and cultural values exert certain influences on buying behaviour. Management should also understand that this continuous interaction between market variables and the variables in the macro-environment gives rise to changes in both environments.

South African businesses operate in a complex market environment, characterised by a heterogeneous population. To determine the market for its market offering, management analyses the total number of consumers in a specific area or market segment and the purchasing power of those consumers by performing market research.

Purchasing power is represented specifically by consumers' personal disposable income. Personal disposable income is the portion of personal income that remains after direct taxes plus credit repayments (loans from banks, shops and other institutions) have been deducted, and is available for buying consumer products and services.

Purchasing power therefore also serves as an interface between the macro-environment and the micro-environment. (Other characteristics of the consumer market that influence purchasing patterns, such as language, gender distribution and size of family, are discussed in more detail in Chapter 13.)

The **consumer market** can further be subdivided as follows, according to the products that are bought:

- Durable products (for example, furniture, domestic appliances and motor cars);
- Semi-durable products (for example, food and tobacco); and
- Services (for example, insurance, rental and Internet usage).

This classification enables management to *analyse* specific segments of the market according to which products or services were purchased.

Besides the market in consumer products, there are also industrial markets (also called the business market) in which products and services are supplied by manufacturing enterprises for the production of further products and services. Government markets involve the purchase of products and services by the central government, provincial governments and local authorities. International markets relate to foreign buyers, including consumers, manufacturers, resellers and governments.

Large and complex, the market environment must be continuously analysed by the business organisation to function successfully. Moreover, variables in the macro-environment, such as economic factors, political trends and upheavals, as well as population growth and urbanisation, also influence the market environment and, eventually, the products and services that the business offers to the market.

Critical thinking

Why salary increases do not necessarily result in more disposable income

Yearly salary increases do not seem to improve the financial well-being of South African workers. One of the main reasons is that modest inflation-linked annual salary increases are gobbled up by higher-than-inflation-linked increases of products and services. The prices of electricity, petrol and consumable goods in South Africa increase at rates higher than the inflation rate. Additional increases in taxes, such as the VAT rate, medical aid payments and pension contributions ultimately result in the consumer's disposable salary just not keeping up with inflation. This is one of the reasons why many salary-earners are caught up in borrowing money and living beyond their means by opening store credit accounts that they eventually cannot repay. Credit bureaus in South Africa are reporting a general increase in the debt levels of consumers, with many people borrowing money from one credit provider to

pay back another credit provider. Is this a feasible practice and what can be done about this issue?

4.5.2 Suppliers

According to the systems approach, a business organisation is regarded as a system that receives inputs from the environment and converts these into outputs in the form of products or services for sale in the market environment. The inputs required are mainly materials (including raw materials, equipment and energy), capital and labour. Suppliers provide these items to businesses. When one considers that approximately 60 cents out of every rand spent goes into purchases from suppliers, the importance of suppliers in the market environment becomes clear. If a business cannot obtain the right inputs of the necessary quality in the right quantity and at the right price for the production of its products, then it cannot achieve any success in a competitive market environment. The interaction between a business organisation and its supply chain is a good example of the influence of environmental variables on the business.

In the case of materials, practically every business, whether it is in manufacturing, trading or contracting, depends on regular supplies. The issue of materials management, scanning the environment with regard to suppliers, and relations with suppliers as environmental variables is dealt with in Chapter 15.

In addition, a business organisation depends not only on suppliers of raw materials, but also on suppliers of capital. Banks and shareholders are such suppliers. They are discussed in Chapter 14. Small businesses in particular find it difficult to raise capital as they usually do not have the necessary collateral, as discussed in Chapter 3.

4.5.3 Labour markets and labour unions

Businesses also need a supply of human resources. This is a special resource that has a very emotive impact on the South African business environment as the country has a very high unemployment rate and a dearth of skilled workers to fill positions in the workforce. It is reported that thousands of jobs in South Africa cannot be occupied because the appropriate skills do not exist in the supply of workers at all levels in the economy. This problem is further exacerbated by a growing gap caused by graduates who leave tertiary institutions without basic workplace skills.

Trade unions and other pressure groups can also be seen as trying to supply skilled workers by their influence on government through the insistence on skills training, and a stable environment in which job creation can occur. In the recent past, labour unions and employers have had a tenuous relationship. In South Africa the government is currently one of the biggest suppliers of employment, which results in an exceptionally large wage bill with little money available for necessary infrastructural maintenance and development. Trade unions are also in crisis with less unionised workers. With the advent of Industry 4.0, attention must be given to the retraining of workers to provide sustainable jobs in the future. All of this indicates that businesses must take note of what is happening in this very dynamic part of the business environment.

The scanning of the environment with particular regard to human resources is discussed in greater detail in Chapter 12.

4.5.4 Intermediaries

Apart from the consumers and competitors with whom management has to deal in the market environment, **intermediaries** also play a decisive role in bridging the gap between the manufacturer and the consumer. Intermediaries form part of the supply

chain and include wholesalers and retailers, agents and brokers, representatives and, in townships, spaza shops. They also include bankers, asset managers and insurance brokers who, from a financial perspective, are also involved in the transfer of products and services.

Decision-making by management in respect of intermediaries is complicated by the dynamic and ever-changing nature of intermediaries. New trends and markets are responsible for the development of new kinds of intermediaries, especially online. Contemporary trends in South Africa in this regard are, for example, electronic shopping, extended shopping hours, the massive increase in shopping centres in the townships as well as the increase in the number of franchises and spazas in these areas, the shift of power relationships from the manufacturer to large retailers because of bar-coding (and the valuable information that it generates) and retailer brand names (the retail chain stores such as Pick n Pay, Spar, Woolworths and Shoprite/Checkers are well known for their 'no-name' or generic brands).

Relationships with intermediaries also complicate management's decision-making as they often involve entering into long-term agreements that may have certain implications for business strategy. The power of large retailers also has certain implications for price and advertising decisions impacting on the relationships with manufacturers.

New trends among intermediaries provide business managers with certain opportunities, but also hold the possibility of threats that must be investigated and addressed.

4.5.5 Competitors

Most organisations operate in a market economy that is characterised by competition in the market environment. This means that every business that tries to sell a product or service is constantly up against competition, and that it is often competitors that determine how much of a given product can be sold and what price can be asked for it.

Moreover, businesses compete for a share of the market and also compete with other businesses for productive resources such as labour, capital and materials. As a variable in the market environment, competition may be defined as a situation in the market environment in which several businesses, offering more or less the same kind of product or service, compete for the patronage of the same consumers. The result of competition is that the market mechanism keeps excessive profits in check, stimulates higher productivity and encourages technological innovation. But while the consumer benefits from competition, it is a variable that management has to take into account in its entry into, and operations in the market.

The nature and intensity of competition in a particular industry are determined by the following five factors (also called the competitive forces):

- **The threat of new entries to the market**. Any profitable market will attract new entrants, which reduces the profitability of the existing businesses. Having no barriers (e.g. no economies of scale) to protect the market will result in new competitors which reduces the profitability of the existing businesses.
- **The buying power of clients and consumers**. The stronger the buying power of clients and consumers is, the less bargaining power the business has, resulting in lower prices that can be charged. Having a few powerful buyers means that the business will have to accept the terms and process dictated by these buyers.
- **The strength of suppliers**. Similar to the strength of clients and consumers, the existence and strength of suppliers may affect the price that can be charged for the

developed product. If the supplier has a unique component that you need to manufacture the product, then obviously this supplier has a dominant position in the market.

- **The number of competitors in the market**. Having many competitors that all deliver an undifferentiated product to the market will reduce the attractiveness of the market.
- **The threat of substitution products availability**. If there are close substitute products available there is an increasing chance that the customer will switch to a substitute product whenever the price of your product increases. This reduces the attractiveness of the market.

These five factors are taken into account when business strategists want to determine if new products or services have the potential to be profitable in the marketplace. The five factors can also be used to identify areas of strength or weaknesses of a business.

The collective strength of these five forces determines the competitiveness in the industry, and therefore the profitability of participants in the industry. Competition varies from intense, in industries such as tyres and retailing, to moderate in the mining and cooldrink industries. The weaker the five forces are, the better the chances are of survival and good performance. Digital technologies and the Internet have also contributed to an increase in competition. E-commerce has reduced entry barriers, widened the geographical span of markets and increased price transparency. It is therefore an important task of management to find a position in the market where the business can successfully defend itself against the forces of competition. The alternative would be to find a position where the business can influence the forces of competition in its favour. This is usually the case when the business is the market leader in turnover or profitability in the specific industry.

Continuous monitoring of competition provides the basis for the development of a strategy. It emphasises the critical strengths and weaknesses of the business, gives an indication of the positioning strategy that should be followed, singles out areas in which strategy adjustments can contribute to higher returns, and focuses on industry trends in terms of opportunities and threats.

The scanning of the market environment for opportunities and threats entails an examination of variables such as the economy and the technology in the macro-environment, as well as trends in the variables within the market environment, namely those factors that influence consumer spending, the labour market, suppliers and competition in the market.

In the market environment, the interaction between a business and its suppliers, the labour force and labour unions, consumers and competitors can result in opportunities or threats to a business. Management must be aware of the trends in the market environment so that the business can exploit opportunities profitably and avoid threats in good time. Environmental scanning, market research and information management are the proper instruments with which to do this (see Chapter 13).

4.6 The macro-environment

4.6.1 The composition of the macro-environment

Apart from the market environment, which has a direct influence on the fortunes of a business, there is a wider macro-environment within which a business also operates. This wider macro-environment has variables that directly or indirectly exert an influence on a business and its market environment. These variables constitute the

uncontrollable forces in the external environment that are sometimes referred to as **mega-trends**.

As Figure 4.2 shows, the macro-environment is divided into six variables or components that a business organisation has to observe and respond to: the technological environment, the economic environment, the social environment, the physical environment, the institutional-political environment and the international environment.

Macro-variables (variables that exist in the macro-environment) have an effect not only on the market environment and on decisionmaking by management, but also on one another, and this constantly causes change in the business environment. In a democratically elected state, the community (which is also the consumer), with its particular culture and values, decides which government it wants, and gives the government a mandate to form a certain governmental structure, which in turn determines the affairs of the community. Therefore, politics is interwoven with the economy and is influenced by the policies adopted and the economic measures taken to achieve political ends. The result is a certain standard of living for the community.

Stimulated by the needs of the community, and with the support of the economy and the government, it is technology that is mainly responsible for the rate of change in the business environment. Social trends also influence politics and the economy. The international environment acts as a considerable force for change in the other variables and therefore in the total business environment. The result of this interaction is often a changed business environment, with new opportunities and new threats.

In studying the macro-environment, the emphasis is on change caused by the uncontrollable macro-variables and the implications for management. Let us look now at these macro-variables.

4.6.2 The technological environment

Change in the environment is generally a manifestation of technological innovation or the process through which human capabilities are enlarged. Technological innovation originates in research and development (R&D) mainly by business, universities and governments. This technological innovation results not only in new machinery or products, but also in new processes, methods, services and, even approaches to management, which bring about change in the environment. Table 4.1 illustrates how the moving assembly line in car manufacturing that forms part of Industry 2.0 (a production process that started just over 100 years ago) enlarged human capabilities and brought about widespread change.

The introduction of the moving assembly line (one of the technological wonders of that time) by Henry Ford in 1913 resulted in a radical reduction in manufacturing effort and costs. Moving from the craft manufacturing process where every car was seen as an individual project to mass production, which was a continuous production process, improved productivity dramatically. Between 1908 and 1913, improved productivity enabled the price of the Model-T Ford to be cut from US$850 to US$360. Consequently, the car was no longer only available to the wealthy elite, but also to a broader section of society, including Ford’s own factory workers, thus expanding the target market for Ford’s automobiles.[16]

Table 4.1: Craft versus mass production at Ford (1913–1914)

Technological innovation also affects other environmental variables. The economic growth rate, measured in terms of GDP, is influenced by the number of new inventions. Social change, in which the appearance of a new product (such as high-definition television or the most recent iPhone) brings about a revolution in people's lifestyles, is also partly the result of technology. Conversely, these variables influence technology, and so the process of innovation and change is repeated.

Technological breakthroughs such as cellphones, fibre optics, arthroscopic surgery, bullet trains, voice-recognition computers and the Internet result in new products and services for consumers, lower prices and a higher standard of living. But technology can also make perfectly working products obsolete – such as the dot matrix printer which, today, is used for only certain security purposes and has been replaced generally by laser and 3D printers.

Every new facet of technology and every innovation creates opportunities and threats in the environment. Television was a threat to films and newspapers, but at the same time it presented opportunities for satellite communications, advertising and instant meals. The opportunities created by computers and the Internet in banking, manufacturing, transport and practically every other industry are innumerable. Moreover, technological innovation often has unpredictable consequences. For example, the contraceptive pill meant smaller families, more women at work, and therefore more money to spend on holidays and luxury articles that would previously not have been affordable. The most outstanding characteristic of technological innovation is probably the fact that it constantly accelerates the rate of change.

A further characteristic of technological innovation that impacts on management is the fact that inventions and innovations are unlimited. Technology influences the entire organisation. The most basic effect is probably higher productivity, which results in keener competition. The ability to produce more and better products threatens organisations with keener competition, compelling them to re-assess factors such as their vision, mission, objectives, strategy, organisational structures, production methods and markets. Superior management of technology within the organisation can be an important source of competitive advantage.

Continued assessment of the technological environment should include the following:

- The identification of important technological trends;
- An analysis of potential change in important current and future technology;
- An analysis of the impact of important technologies on competition;
- An analysis of the business's technological strengths and weaknesses; and
- A list of priorities that should be included in a technology strategy for the organisation.

In a developing country such as South Africa, managers should continually assess technology trends that revolve around the following:

- **Water technology.** South Africa's water resources can sustain only 80 million people. SABMiller is a prime example of an organisation that is managing its natural resources efficiently. The world's consumption of water has grown at about twice the rate of its population in the past century alone. South Africa has its own unique problems with water resources, such as the ones seen with the acid mine water problem, as well as the deterioration of the quality of water of the major rivers in the country.
- **Mineral technology.** South Africa has vast mineral resources, and new ways to improve the processing of its mineral treasures should continually be assessed.

Currently, hydraulic fracturing is in the news. It is expected to deliver petroleum and gas which will be used to alleviate dependency on imported petroleum products. There is, however, strong antagonism from environmentalists towards this type of extraction, with critics pointing to the dangers of contamination of groundwater, and the subsequent negative impact on humans. See also the De Beers example discussed previously where new mining techniques are being used to extract diamonds from the Venetia diamond mine.

The threat of acid mine water

Disused mines are scattered over the northern provinces of South Africa and a number of poorer communities are living on this disused land. This land has been contaminated with high concentrations of cobalt, zinc, arsenic and cadmium, all known carcinogens, as well as high levels of radioactive uranium, all of which are extremely harmful to humans. Added to this is the problem of acid mine drainage (AMD) that is already decanting into the rivers of South Africa. AMD is a process that is found where mining activities have occurred below the water table. Pumps must drain the water that streams into the mine to prevent flooding. When the mine is eventually abandoned, the pumping stops and the subterranean water floods the mine, eventually seeping out of the mine at ground level.

- **Marine technology.** This is needed to utilise South Africa's vast coastal and oceanic resources. Refer to the De Beers case study, which refers to the mining of alluvial diamonds at the coast between South Africa and Namibia.
- **Agricultural and veterinary technology.** South Africa is one of few countries that allow the genetic modification of crops. Genetically modified (GM) maize and corn can, for example, make crops more drought resistant, but also pose threats to biodiversity. Technology in this area therefore needs to be assessed continually to find a balance between providing food to the African continent while still preserving Africa's wildlife and tourism.
- **Medical technology.** This technology is used to assist the population in extending life expectancy, preventing epidemics and supporting the sports industry, among others, which is a growing billion-rand industry in South Africa.
- **Transport technology.** This is needed to provide transport for people who reside far from their places of work. Transport in South Africa is an increasingly important issue because of the country's continuing urbanisation. The Gautrain is one example of the use of transport technology to solve mass transportation problems.
- **Power technology.** This is needed to harness cheaper and environmentally friendly forms of power, such as solar power. The need for power or electricity in South Africa has increased exponentially in recent decades. South Africa's current infrastructure cannot support this increased demand, and power failures and load shedding have become a standard occurrence. Apart from causing inconvenience, the continued lack of sufficient power reserves has led to the cancellation of downstream beneficiation facilities for certain raw materials in South Africa. This has obviously had some negative consequences for employment opportunities and capital investment and is reducing the country's economic growth rate.

Technological progress affects a business as a whole, including its products, its life cycle, its supply of materials, its production process and even its approach to management. These influences all require management to be increasingly on the alert regarding technological change.

Technology and changes in lifestyle

Technology has an immediate and lasting impact on society in general and on people's lives in particular. Some of these changes include the following:

•In the early 19th century, railways opened up the hinterlands of America and England.

•In the 19th century, electricity began to revolutionise people's lifestyles through the introduction of washing machines and refrigeration.

•Since the beginning of the 20th century, the motor car has brought radical changes to the development of cities and the workplace.

•The advent of the passenger jet in the 1950s transformed tourism into the world's major industry within a few decades. The Boeing 747 aircraft is seen as the vehicle that opened up air transport to the masses, resulting in cheap airfares, and a massive increase in exotic holiday destinations across the world.

•People are now experiencing the impact of micro-electronics. What used to be a room-sized computer is now found in a miniature chip. The effect of micro-electronics is that it results in ever-smaller units of production that nevertheless yield the same, or even improved, returns.

•Advances in nanotechnology are now dramatically changing industries such as healthcare and mining. Miniature robots are circulating in human arteries to fix life-threatening sicknesses such as clogged arteries.

•Cellphones have revolutionised communication and are seen as merging different products into one – for example, the use of cellphones to access the Internet has almost obviated the use of personal computers.

•The Internet has created opportunities for real-time social networking across the globe by means of web-based applications such as Facebook and Twitter (which more and more business executives are using to market their firms). There is growing evidence that more consumers are using online purchasing as the default option when shopping for a wide range of products. The success of Takealot and Parcelninja during Black Friday sales bears testimony of this growing trend.

Critical thinking

The management of a state-owned enterprise, especially one on which citizens of a country rely heavily, has repercussions on the day-to-day livelihood of all consumers in South African society. Currently Eskom and SAA are in the news, demanding massive amounts of money from government to resuscitate and keep these businesses afloat. The question has to be asked: could this money not be better spent on more worthwhile projects to uplift the South African economy and its population?

4.6.3 The economic environment

After technology, which is primarily responsible for change in the business environment, there is the economy, which is influenced by technology, politics, and social and international environments, and in turn also influences these variables. These cross-influences continuously cause changes in, for example, the economic growth rate, levels of employment, consumer income, the rate of inflation, interest rates and the exchange rate. Ultimately, these economic forces have implications for management that must be considered.

Inadequate power supply and production[17]

Eskom has the monopoly in electricity generation in South Africa. In the past few years, Eskom has found itself in a position where electricity demand has exceeded supply. In an attempt to manage the energy shortage and to try to meet demand, Eskom used a last-resort measure that interrupted electricity supply to certain areas of South Africa. This is termed load shedding. Eskom's load-shedding programmes reached a climax in the last quarter of 2014, severely affecting South Africa's economy and productivity, especially in the manufacturing and mining sectors. Load shedding therefore not only affected businesses

and industries, but also had a negative effect on South African households and the economy in general.

During the load-shedding period, businesses and households invested in alternative energy supplies (such as solar power, biomass processes that deliver methane gas, wind farms, and generators). Government is also interested in developing alternative energy sources and has been in discussions with private suppliers of alternative energy to supplement the electricity supply grid.

Currently there is general concern about a number of issues at Eskom. These issues include the instability of available power plants, the financial liquidity of the utility that is being hammered by the use of very expensive diesel to maintain a constant supply of electricity, the unreliable supply of electricity, the slow progress with the build programme of new power stations, and the time and cost overruns at Medupi and Kusile power stations, which have doubled the cost and time frames for delivery. All of this is impacting on the growth prospects of the South African economy which is very dependent on a stable electricity supply.[18]

The question arises, is alternative electricity source generation a viable option to alleviate the pressure on Eskom? Is there a life off the national electricity grid for South African businesses and consumers?

The economic well-being of a country, or its economic growth rate, is measured by the range and number of products and services it produces. Expressed in monetary terms, this standard is known as the gross domestic product (GDP), which is the total value of all the products and services finally produced within the borders of a country in a particular period (usually one year).

A high economic growth rate of around 7–8 per cent per year or more in real terms signals an economy that is growing quickly enough to create jobs for its people, exports more products than it imports to sustain a positive trade balance and a stable currency, and provides its people with an improved standard of living. A low economic growth rate, especially one that is below the population growth rate, usually lowers people's standard of living.

Between 1999 and 2006, South Africa saw the longest period of uninterrupted economic growth in its history. In fact, during the second quarter of 2006, GDP grew at an annualised rate of 4,9 per cent, one of the highest rates in the world at that stage. Although South Africa needs a growth rate of over 7 per cent per year in real terms to provide jobs for the millions in the unemployment queue, the economic story until 2008 was a relatively good one.[20] The 2008 world economic recession, however, also affected the South African economy, resulting in job losses and lower profitability for businesses. By 2018 the South African economy was growing at a sluggish rate of below one per cent and it is estimated that South Africa will struggle to obtain a growth rate of above 2 per cent per annum in the immediate future.

A country's economic growth rate influences consumers' purchasing power, which can, in turn, give rise to changes in both spending behaviour and the type of products or services purchased.

Management must take note of structural changes in the incomes of different consumer groups and adjust its strategies accordingly. In addition to monitoring the economic growth rate, management must also monitor the business cycle very carefully. The correct assessment of upswing and downswing phases in the economy is essential to the strategy of any business. If management expects a recession, it can, for example, reduce its exposure by decreasing inventory, thereby avoiding high interest-rate costs. Any plans for expansion can also be deferred.

In an upswing (or boom period), the right strategy may be to build up sufficient inventory in good time and to carry out whatever expansion is necessary.

Inflation, like economic growth, is an economic variable that affects the decisions management has to make. During the 1960s, South Africa had a very low inflation rate, but from the mid-1970s, double-digit inflation became a regular phenomenon. From 1974 to 1992, the average annual rate of consumer price increases amounted to 13,8 per cent. But since 1993, single-digit price increases, comparable to those of the early 1970s, were again recorded because of improved monetary discipline. South Africa is using an inflation-targeting policy to keep the inflation rate in check. The South African Reserve Bank sets an explicit target inflation rate for the period and uses mainly interest rates as its main instrument to keep the inflation rate within the established band of 3 to 6 per cent per annum.[21]

The costs and effects of inflation on a business need to be analysed and managed on a permanent basis. Inflation increases the costs for exporting industries and also for local industries competing against imported products. When a country's inflation rate is higher than that of its major trading partners and international competitors, there is a reduction in its international competitiveness. This is still the case with South Africa because its inflation rate is still higher than most of the world's important trading countries.

Another economic variable affecting a business and its market environment is the government's **monetary policy**. This influences the money supply, interest rates and the strength of the currency, and therefore has important implications for management. High interest rates result in a high cost of credit, which tends to modify behaviour and results in a subsequent decline in consumer spending and fixed investment. South Africa's prime interest rates remained stable at 9,25 per cent for an extended period, but the prime rate increased to 10,25 per cent in November 2018 with further rate increases very likely in the immediate future.

The government's fiscal policy, in contrast, affects both businesses and consumers through taxation and tax reforms.

The economic trends discussed above demand constant examination by the management of a business.

4.6.4 The social environment

The environmental variable that is probably most subject to the influence of other variables (especially the impact of technology and the economy) is the social environment. This affects the management of a business indirectly in the form of changing consumer behaviour and directly through the employees who work for the business.

Humans are largely products of their society. As members of a particular society, they accept and assimilate their society's language, values, faith, expectations, laws and customs. The way of life of a group of people influences the individual's way of life, so consumption cannot be explained solely in economic terms. Consumption is also a function of demographic change.

4.6.4.1 Demographic change

Demographic change is change in the growth and composition of populations. Demographic change is probably the social variable that causes the most change in the market. It does so by altering people's ways of life.

Societies in the developed world are characterised by falling population-growth rates and shrinking families, with the emphasis on smaller consumer units. There are

growing numbers of one-person households and, consequently, a growing demand for services. There is also a growing population of ageing, affluent people, whose needs give rise to special business opportunities, such as in the tourism and the secure old-age living industry.

In the developing world, population growth and poverty remain prominent issues, causing great concern to governments, policy-makers and environmentalists. The concerns surrounding high population-growth rates in developing countries revolve around poverty, the supply of infrastructure, pollution and degradation of the environment, as well as illness and famine. More than a third of the world's population is living below the poverty line and is in danger of starving. All of these concerns have a profound effect on business, especially in Africa. Currently, South Africa accounts for a third of all new HIV infections in Southern Africa, with more than 4,4 million people on antiretroviral (ARV) treatment.[22]

Demographics and its impact on consumer behaviour[24]

Customers are, in general, influenced by various factors when they make purchasing decisions. Some of these influences can be broken down geographically, with the sub-Saharan Africa region having its own unique purchase decisions. Nigeria, as the largest economy in Africa, has little racial diversity, with African people making up the majority of the population. This fact makes it easier for businesses such as food manufacturers to identify a target market as there are more commonalities in food culture and food consumption patterns. The consumer's purchase decision is also influenced by culture. In Nigeria, for instance, women are considered homemakers. They make most of the purchase decisions regarding consumer products.

Customers in Kenya mainly eat the staple food ugali (maize meal), as has been the tradition for centuries. Introducing new food products that challenge tradition is perplexing, making the entry of new rival foods difficult in this country. Household income size also plays a role in the buying behaviour. In Kenya, household income is low, which restricts growth opportunities and the acquisition of non-essential products as customers focus on acquiring basic food products. Packaging sizes are also bigger due to average family sizes being larger, making larger packaging more economical.

South Africa, as the second-largest economy in Africa, has multiple race groups and a more diversified cultural profile that requires manufacturers and retailers to cater for many needs in various sub-markets. On the other hand, it also provides opportunities as customers are more amenable to trying out different foods. Here, the different cultures make customers aware of various food products such as pizza, hamburgers and fries, Chinese food, Thai food and Indian food. This broadens the scope of selling more specific foods such as pizza. Incomes are higher than those in other African markets, creating more opportunities for retailers to sell luxury products in South Africa. The size of South African households is also smaller, allowing manufacturers and retailers to sell products in smaller packaging sizes.

The most recent estimation of the total population in South Africa stands at 57,73 million people in 2018 up 325 per cent from 17.4 million in 1960.[23]

Changes in population-growth patterns, as well as other demographical factors such as age, have an effect on consumers' needs, income and behaviour.

4.6.4.2 Urbanisation

Changes in population-growth patterns are influencing the geographical distribution and mobility of the world's population.

The movement of people from rural areas towards cities is known as **urbanisation**. Urbanisation is one of the foremost trends of the world's population. Estimates of the future spread of urbanisation are based on figures which show that in 2018, more than

70 per cent of the populations in Europe (74,5 per cent), North America (82,3 per cent) and other richer developed nations were already living in urban areas. Although Africa and Asia compare weakly, with 42,5 and 49,9 per cent respectively living in urban areas, the highest growth rate in urban populations is found in developing regions. In 2018, the proportion of the global population living in urban areas had increased to 55,3 per cent and is expected to rise to 68 per cent (adding another 2,5 billion people) by 2050, with millions of people joining towns and cities in Asia and Africa.[25] Urbanisation therefore affects businesses in many ways, especially in the areas of housing, sanitation, slum control and health services.

4.6.4.3 Level of education

Another social trend that will greatly affect management is the level of education of the population. Where the level of education is increasing, this will, on the one hand, raise the level of skills of both managers and workers and, on the other hand, will result in an increased demand for books, magazines, newspapers and online information resources. There is a commitment from government to pursue a strategy of improving the tertiary qualifications level of South Africans, and in 2017 it was announced that free higher education will be introduced for all deserving candidates. This will be phased in over a period of time and will cost the government and the taxpayer billions, placing a further demand on the list of ever-increasing demands on the budget.

Urbanisation and the consumption of milk in Africa[26]

There has long been a belief that fresh milk bought daily is the right thing for growing children to drink. It will therefore come as a surprise that ultra-high-temperature (UHT) milk sales in South Africa is expected to reach an estimated value of USD 1185,3 million in 2019. Various reasons are given for why UHT milk has outsold fresh milk in South Africa. Some of these are as follows:

- A growing urbanised middle class. Urbanised people prefer using UHT milk as most of them acquired the taste growing up. There is also the convenience factor of long life that makes UHT milk attractive to these customers.
- Another reason for the preference for UHT milk is a lack of electricity and fridges, with one third of the population not having access to refrigeration. Eskom’s load shedding is also influencing the sale of fresh milk.
- Africa, as a developing market, promises outstanding growth opportunity for milk producers due to the increase in the size of the middle class, urbanisation and the low consumption of milk. The inconsistent supply of electricity will be a growing problem for milk distributors, overcome only by the substitution by other milk products such as UHT milk and milk powder.

Higher education levels has resulted in lower unemployment[27]

In South Africa’s 2011 Census, it was found that 66 per cent of South Africans with no form of education were living in poverty. Completing primary schooling reduced the poverty level to 55 per cent, while completing secondary schooling resulted in only 23,6 per cent living in poverty. Obtaining a higher education qualification at tertiary level reduced the chances of poverty further to 5 per cent. In research done in 2016, 85 per cent of scholars aspire to get a university education as tertiary education is seen as a way to obtain a well-paid job. It is reported that the unemployment level of graduates is 7 per cent while 26 per cent of other young people remain unemployed.[28]

4.6.4.4 The changing role of women

Another social variable with clear implications for management is the changing role of women in developed societies. As recently as 17 years ago, 60 per cent of American

women believed that a woman's place was in the home. Now only 22 per cent are of that opinion. The percentage of top female managers in South African businesses now stands at 29 per cent.[29] There is great concern about this trend and much research has been undertaken in this regard to understand the stagnation in the appointment of top female managers in large businesses and government institutions.

4.6.4.5 Consumerism

A further social trend to be considered is consumerism, the social force that protects the consumer by exerting legal, moral, economic and even political pressure on management. This movement is a natural consequence of a better educated public that resists such things as misleading advertisements, unsafe products, profiteering and other objectionable trade practices, and presses for the rights of the consumer. In a market system, these rights are generally recognised as the following:

- The **right to safety**, which entails protection against products that may be dangerous or detrimental to life or health;
- The **right to be informed**, which means objective information is provided to enable the consumer to make rational choices;
- The **right to freedom of choice**, which entails giving the consumer access to competitive products or substitutes, and protects against monopolies; and
- The **right to be heard**, which means that consumers are given the assurance that their interests will receive attention from the government and related parties.

The South African government, through the Department of Trade and Industry (the DTI) is responsible for the application of the Consumer Protection Act (No. 68 of 2008). Various institutions are involved in the policing of the act.

4.6.4.6 Social responsibility and business ethics

Another important aspect of the social environment is the pressure that society exerts on business organisations, forcing them to seek legitimacy by being socially responsible. This means that business organisations should not only seek to maximise the value for their shareholders, but also constantly consider the consequences of their decisions and actions on society. Well-known management scholars Ghoshal, Bartlett and Moran maintain that organisations should seek compatibility of their own interests with the interests of society while striving for overall value creation.[30] Consumers are realising that although businesses produce much of what is good in society, they also cause great harm. Management is mostly criticised for misleading advertising, dangerous products, pollution of the environment, job lay-offs, industrial accidents, exploitation of the consumer and other consequences.[31] Organisations are therefore called upon to be socially responsible.

Corporate social responsibility (CSR) can be defined as 'the broad concept that businesses are more than just profit-seeking entities and, therefore, also have an obligation to benefit society'.[32]

While profits and employment remain important for the stakeholders, many other factors are included in assessing the performance of a business. These include equity or the empowerment of designated groups (economically and managerially), housing, response to environmental concerns, provision of a responsible and safe workplace, care about health issues and involvement with communities.

Some businesses perform an annual social audit to measure their social performance. Based on the results of the social audit, a business can review its social responsibility. However, the crux of social responsibility is the community's insistence that a business is a good corporate citizen in every respect – one that produces profit for

owners and investors, but simultaneously markets safe products, combats pollution, respects the rights of employees and consumers, and assists the disadvantaged. In short, businesses are expected to promote the interests of society.

In South Africa, corporate social responsibility seems to play an especially important role. The government alone cannot be expected to rectify the inequities of the past at a rate that is fast enough to alleviate poverty. Though South African businesses spend millions on social investment, they remain under pressure to uplift the disadvantaged. In future, in South Africa and elsewhere, pressure will intensify and may even give rise to a more regulatory environment.

Table 4.2 shows the various aspects according to which society judges a business's social performance.

Table 4.2: The social responsibility of business

Area of social responsibility	Issues in social responsibility	Laws/regulations pertaining to social respo
Social responsibility to employees (workplace responsibility)	•Equal employment opportunities •Developing a quality workforce (training and the skills-development levy) •Gender inclusion •Access for disabled persons •Sexual harassment awareness •Respect for diversity •Safe working conditions	•Employment Equity Act (No. 55 of 1998) •Skills Development Act (No. 97 of 1998) •Gender Equality Act (No. 39 of 1996) •Mine Health and Safety Act (No. 29 of 1996) •Public Service Amendment Act (No. 30 of 2007
Social responsibility to the consumer and customers	•Safe products and services •No misleading advertising or communication •Proper information about products and services	•Consumer Protection Measures Act (No. 95 of •Consumer Protection Act (No. 68 of 2008)
Responsibility to the investor and financial community	•No deceptive accounting reports •Accuracy of financial reporting •No insider trading •No bribes to customs or other government officials	•South African Statement of Generally Acceptec Practice (GAAP), as approved by the Accountin •The 'Code of Corporate Practices and Conduct principles of good governance, as set out in the 2009, and the King IV Report on Corporate gove Africa of 2016.
Social responsibility to the general public	•Natural environment issues, including conservation and pollution control •Public health issues such as HIV/Aids •Housing for the poor •Philanthropic donations •Social welfare •Avoiding unlawful competition	•World Heritage Convention Act (No. 49 of 1999 •Housing Act (No. 107 of 1997) •Welfare Laws Amendment Act (No. 106 of 199

As a concept, **business ethics** is closely related to social responsibility, except that business ethics has to do specifically with the ethics or the ethical behaviour of managers and executives in the business world.

Ethics can be defined as 'a guide to moral behaviour based on culturally embedded definitions of right and wrong'.[33] Managers, in particular, are expected to maintain high ethical standards.

At issue here is the integrity of entrepreneurs and managers, and the degree to which their decisions conform to the norms and values of society. Business ethics revolves around the trust that society places in people in business and the obligations that these businesspeople have towards society.

Greed, seen as a disproportionate desire to obtain more (money or assets) than is needed or warranted, results in accusations about the exploitation of workers and consumers, and questions about the abuse of positions of trust. This has caused the ethical conduct (business ethics) of entrepreneurs and managers to be questioned in South Africa. Criticism has also been aimed at the core essence of the economic system of capitalism. Capitalism survived its main rival, the command economy (also called communism), and has since been feted as the best available economic system in the world. Since the depression of 2008, the suitability and sustainability of unbridled capitalism has been brought under the spotlight. Worldwide, there are instances of businesses and managers having misused capitalism to their own advantage – such as Enron and Tyco in the USA and Saambou, LeisureNet, the African Bank saga and Steinhoff in South Africa. These can be seen as cases where greed triumphed over basic economic common sense and where the basic principles of the renowned economist Adam Smith's 'invisible hand' failed to rein companies in that were overly dominant in their markets. This resulted in business thinkers postulating new economic theories aimed at creating more social harmony and more meaningful social relationships between society, stakeholders and businesses in general. In fact, there is now a drive to obtain a better balance between business and society's best interests with the ultimate aim of fairness and human integrity.

South Africa as a country is also under scrutiny regarding unethical behaviour. Walmart, the global retailing chain that started operations in South Africa when it acquired Massmart, has identified South Africa as one of the five countries with the highest corruption risk. The other four countries were Brazil, China, India and Mexico.

Corporate governance was institutionalised by the publication of the King Report on Corporate Governance (King Report I) in November 1994. This was superseded by the 2002 King Report on Corporate Governance in South Africa (King Report II). The purpose of the Code of Corporate Practices and Conduct contained in these reports is to promote the highest standards of corporate governance, and therefore business ethics, in South Africa. The King Report on Corporate Governance (King Report III) of 2009 updated the earlier reports, incorporated a number of important changes, and took effect on March 2010.[34] In 2016 the King IV Report on Corporate Governance for South Africa was introduced to further strengthen corporate governance in South Africa.

Many South African organisations, however, have responded to the call for socially responsible and ethical behaviour. Chapter 5 discusses ethics and social responsibility in more detail.

4.6.4.7 HIV/Aids

HIV/Aids is a huge social problem. It is estimated that the population of South Africa could have been 4,4 million larger if it were not for Aids. Information estimates are that 18, 8 per cent of the population between the ages of 18 and 49 have contracted

HIV/Aids. It is further estimated that the total number of people living with Aids in South Africa was 7,2 million in 2017.[35]

Management needs to take cognisance of this global problem and develop strategies and programmes to deal adequately with HIV/Aids in the workplace as it impacts on workers employed by the business.

4.6.4.8 Culture

Culture is another social variable that influences organisations in a number of ways. In South Africa, new cultural values are emerging among young urban black people. For example, the extended family living under one roof is falling out of favour, women have become more independent, and negative attitudes towards marriage and large families are frequently expressed. The shape of the market, the influence of the culture that currently enjoys political power and the attitude of the workforce are only a few of the numerous ways in which culture can affect an organisation.

Social problems such as the HIV/Aids epidemic and poverty bring about developments that cause change in the environment. Management cannot afford to ignore these social influences.

4.6.5 The physical environment

The physical environment refers to the physical resources that people (and businesses) need to support life and development, such as water, air, precipitation, the oceans, rivers, forests and so on. Environmentalists warn that if the biomass, which maintains a life-sustaining balance, is damaged beyond repair, human beings will simply cease to exist. With approximately 7,4 billion people[36] relying on the resources of the same planet, governments and businesses are now beginning to realise that the plundering of physical resources may endanger countries and even continents.

Currently, the numbers of domestic stock are too high, and the quantity of crops and other biomaterial that people extract from the earth each year exceeds, by an estimated 20 per cent, what the planet can replace.

The influence of generations on the business[37]

There are different generations at work in the South African workplace and there is strong evidence that generations differ regarding social behaviour and consumption patterns. Generations can be described as a group of people who share a number of similarities (such as years of birth, age and memories) and significant life events (such as growing up during a depression or under a specific political dispensation). There are, broadly speaking, four generations at this time:

1. The silent generation, also called the traditionalists, is the generation born before the Second World War (1939). This generation has encountered special circumstances such as a world war with all its deprivations, and an explosion of new workplace technologies, ranging from fax machines to computers and cellphones. They are traditional, believe in hard work and being loyal to the business for which they work and to family, friends and their country. This affects their consumption patterns.
2. The baby boomers are so named because they were born in the period just after the Second World War when there was an upsurge in the population with all the returning soldiers settling in to find a job and get married. This generation was born after 1945 until 1965. They are optimistic team players who expect nothing for free and believe in hard work.
3. Generation X is the generation born from 1965 until the mid-1980s. They generally have a more cynical and jaundiced view of life. They are characterised by being more independent, and they question authority.

4.The millennials were born between 1985 and 2005. They are seen as more entitled, slothful, disrespectful of authority, and even egotistic. They are the users of social media platforms such as WhatsApp, Twitter and Skype, which has led them to keep their communication style short and direct. This affects their communication practices in the workplace.

Chapter 12 discusses generations further.

Regarding the physical environment, the issues of most concern include:

•**Overpopulation.** Despite a slowdown in world population growth, the number of people is still rising. In poor countries, mostly in Asia and Africa, population growth leads to land degradation, pollution, malnutrition and illness.

•**Food.** There are 821 million people facing chronic food deprivation in the world.[38]

•**Water.** The growth in water usage is outpacing supply, and agricultural run-off and urban discharge are polluting the rivers. Within the next 25 years, two-thirds of humanity may live in countries that are running short of water. Only 2,5 per cent of the earth's water is freshwater, and only a fraction of that is accessible, despite the fact that each person needs 50 litres per day for drinking, cooking, bathing and other needs. At present, slightly more than one billion people lack access to clean drinking water and 2,6 billion people lack adequate sanitation.[39]

•**Energy and climate.** The demand for energy is growing worldwide, but 1.1 billion people have no access to electricity and nearly 2.8 billion lack access to clean cooking.[40] Most of South Africa's power is provided by Eskom, whose production capacity is currently extremely strained. In general, the world is overly dependent on fossil fuels, such as oil and coal, that result in heavy air pollution. Air pollution promotes global warming and climate disruptions. The realisation that people need a safe, clean, affordable, diverse supply of energy has led to billions being invested in energy research and development.

•More than 27 000 of all species are threatened with extinction.[41] Many vanishing species provide humans with both food and medicine. Some of the traditional fish stocks found in abundance on the South African coast are now on the brink of extinction.

The physical environment influences business simply because it is the environment from which business obtains its physical resources. It is also the environment into which business discharges its waste. The following interfaces with the physical environment present opportunities as well as threats to a business:

•**The cost of energy.** Fluctuations in oil prices directly affect the business organisation's environment and dramatically affect the political, economic and international landscape. As a consequence, this presents threats to, and opportunities for, business. The increasing cost of energy has launched the most widespread drive for technological innovation the energy sector has ever seen and has led to alternative energy sources now being considered. Research on solar power, wind power and nuclear power has been intensified, and offers many opportunities to entrepreneurs.

•**The growing cost of pollution.** Pollution costs the community a great deal in terms of destroyed living space, as well as expenses related to the prevention and remedying of pollution. Complying with laws designed to minimise pollution can also be expensive. Here opportunities present themselves – for example, in the form of new methods of producing and packaging products to keep pollution to a minimum. Another opportunity lies in the recycling of products and the development of alternative energy sources from household trash. Some of the more

modern types of alternative energy generation come from landfills where methane is generated and harvested to be used, for instance, in heating plants. Basic household waste of biological origin such as vegetables and fruit can be used as biodegradable waste, which can also be utilised in the development of alternative energy sources.

- **Environmentalism.** Many opportunities for entrepreneurs exist in the fields of conservation and ecotourism.
- **Scarce resources.** A broad range of resources that are becoming increasingly scarce (for example, declining oil reserves) is a matter of concern for entrepreneurs. Shortages affect the supply of products and can cause severe price rises. However, shortages also create opportunities, since they often necessitate different methods of production or substitute products, as occurred with the development of solar power.

Businesses should respond to the vulnerability of the physical environment by taking timeous steps to limit any harmful effects on the community. If managers do not show clear signs of a sense of social and environmental responsibility, they should not be surprised if hostile relations develop that may threaten the survival of the business.

Various industries have taken steps to limit their damage on the physical environment. For example, the soap industry is carrying out research on less harmful chemicals, the fast-food industry is developing containers to reduce litter and the motor industry is being compelled by legislation to design emission systems to minimise pollution.

Critical thinking

How should concern of the physical environment influence management decision-making in South Africa?

4.6.6 The institutional–governmental environment

Management decisions are continually affected by the course of politics, especially the political pressures exerted by the ruling administration and its institutions. As a component of the macro-environment, the government affects the business environment and business enterprises in a regulating capacity (as explained in Chapter 1). The government intervenes in the macro-environment on a large scale and influences it by means of legislation, the annual budget, taxation, import control (or a lack of it), the promotion of exports, import tariffs to protect certain industries against excessive foreign competition, price controls for certain products and services, health regulations, incentives to encourage development in a specific direction, and so on. The National Development Plan (NDP) is a South African government policy document designed to eliminate poverty and to reduce the high levels of inequality in South Africa by 2030. Among other things, this plan points out the key constraints on faster growth and how to address the country's socio-economic imbalances.

Furthermore, the government influences the market through government expenditure. Whenever the government acts as a producer or supplier of services, as in the case of numerous businesses (for example, Eskom, the Post Office or SAA), it competes with private enterprise for labour, materials and capital. To an increasing extent, it is the task of management to study the numerous and often complex activities of government, as well as legislation and political developments, to determine their influence on the profitable survival of the business.

The current political dispensation in South Africa, with its form and philosophy of government, has resulted in power bases, with far-reaching consequences for the South African business environment. The labour laws and the Employment Equity Act (No. 55 of 1998) and subsequent amendments are examples of how the government influences the management of businesses. A further issue that is impacting on business, and South Africa in general, is the proposed scrapping or amending of section 25 of the Constitution dealing with property rights. This scrapping will allow for the expropriation of land without compensation in certain clearly defined circumstances. Section 25 is a pillar for the economic security of both citizens and businesses and is seen as a basic fundamental human right that is protected in terms of international human rights instruments such as the United Nations Universal Declaration of Human Rights, the European Convention on Human Rights and the African Convention on Human Rights (African Charter on Human and Peoples' Rights).[42]

One of the most critical tasks facing businesses is to retain well-qualified, skilled employees in order to carry out the Employment Equity Act (EEA) (No. 55 of 1998). A major development in the institutional environment was the release of the Companies Act (No. 71 of 2008). This bill replaces the Companies Act (No. 61 of 1973) and amends the Close Corporations Act (No. 69 of 1984). The implications of this act are discussed in more detail in Chapters 3 and 4.

4.6.7 The international environment

While each of the factors discussed so far exerts, to a greater or lesser extent, an influence on the business environment, the situation is rendered even more complex, with even more opportunities and threats, if an international dimension is added. Businesses that operate internationally find themselves in a far more complex global business environment because every country has its own peculiar environmental factors, technology, economy, culture, laws, politics, markets and competitiveness, and each is different from those of every other country. In the international environment, South Africa is also a player that punches above its weight. It is part of the BRICS countries which promote commercial, political and cultural co-operation between the nations of Brazil, Russia, India, China and South Africa. BRICS was established in 2011. Among other things, it launched its own development bank, the New Development Bank (NDB) in 2015 to assist with lending money to these five countries for economic growth.

International and multinational organisations are susceptible to all kinds of international currents and trends. For example, De Beers is vulnerable to changes in the market environment of the countries in which it mines and sells diamonds. The De Beers case study showed how the organisation is exposed to price pressures and increased competition.

The new economic order taking shape worldwide is indicative of the increasing globalisation of the world economy. Globalisation and the trend towards a borderless world continually affect businesses in new ways. However, globalisation does not only present opportunities – it also poses threats as manifested in current international issues such as Brexit and problems between EU countries about running deficits on their domestic budgets. Management must therefore constantly assess possible global threats to its markets and products.

4.7 Opportunities and threats in the market environment and the macroenvironment

The changes brought about in the market environment by the respective variables and their interactions, as well as the trends that constantly develop in the macro-environment, may be classified into two groups:

- •Changes that offer an opportunity; and
- •Changes that pose a threat.

An **environmental opportunity** may be defined as a favourable condition or trend in the market environment that can be exploited to the business's advantage by a deliberate management effort. However, it should be clearly understood that the possibilities inherent in an opportunity always have to be assessed against the background of the organisation's resources and capabilities (the strengths and weaknesses in the microenvironment). Without the necessary capabilities and resources, an opportunity cannot be properly exploited. The success of a business in making good use of an opportunity therefore depends on its ability to satisfy the requirements for success in that particular market.

In contrast to an environmental opportunity, an **environmental threat** may be defined as an unfavourable condition or trend in the market environment that can, in the absence of a deliberate effort by management, lead to the failure of the business, its products or its services. In view of the constant changes in the market environment, it is the task of management to identify such threats, both actual and potential, and to develop a counter-strategy to meet them.

Knowledge of trends in the environment, along with the identification of those issues that largely determine a business's course of development, is also necessary to make the decisions that will maximise profitability. For this, scanning the environment is a necessary management task. It enables management to identify threats and demands from the environment and, wherever possible, to turn these into opportunities.

4.8Environmental scanning

The degree to which the environment influences the management of a business depends largely on the type of business, and the goals and objectives of its management. Moreover, environmental influences differ from one management area to the next, and even at different levels of management. This means that the importance, scope and method of **environmental scanning** – that is, the process of measurement, projection and evaluation of change regarding the different **environmental variables** – differ from one organisation to the next.

The importance of environmental scanning may be summarised as follows:

- •The environment is continually changing; therefore, purposeful monitoring is necessary to keep abreast of change.
- •Scanning is necessary to determine which factors and patterns in the environment pose threats to the present strategy of a business.
- •Scanning is also necessary to determine which factors in the environment present opportunities for a business to attain its goals and objectives more effectively.
- •Businesses that systematically scan the environment are more successful than those that do not.
- •In the 50 years between 1920 and 1970, almost half of the 100 largest organisations in the United States failed because they did not scan the environment adequately and adapt themselves to change accordingly.

The extent of environmental scanning is determined by the following factors:

- •The basic relationship between a business and its environment;

- The nature of the environment within which a business operates, and the demands made by the environment on a business (the more unstable the environment and the more sensitive the business is to change, the more comprehensive the scanning has to be; increasing instability usually means greater risk); and
- The source and extent of change (the impact of change is rarely so compartmentalised that it affects only one or two areas of an organisation; change has an interactive and dynamic effect on several aspects of a business).

The best method of environmental scanning is a much-debated subject. It will largely be determined by the importance the business attaches to the environment and by the amount of scanning required. The following are a few guidelines that may be followed:

- The most elementary form of scanning is to update relevant secondary or published information obtainable from a wealth of sources such as the media, the organisation's own data, professional publications, financial journals, statistics, associates in other organisations, banks, research institutions, records in the organisation's own filing system and employees.
- The more advanced form of scanning is the addition of primary information or special investigations on particular aspects of the environment. Such investigations can be carried out by members of the organisation's own staff or by outside consultants.
- Scanning at a much more advanced level could mean the establishment of a scanning unit within the business. The unit should have its own staff, who monitor a broad range of environmental variables and make forecasts about some of these (such as technological predictions by industrial analysts, and economic predictions and market assessments by economists using a number of models). Such a scanning unit is usually located in management's planning department. The question that then arises is how all the collected information can be brought to the attention of the relevant manager. There are many different opinions about this, the most common being that information about the environment forms the foundation of strategic planning since it influences the types of strategies likely to be successful.

4.9 Summary

A business and the environment in which it operates, including the community that it serves, depend on each other for survival. Together they form a complex dynamic business environment where change in the environmental variables continually determines the success or failure of a business. Because these variables are often beyond the control of management, it is management's task to adapt the organisation to change in the environment. At times, management acts proactively by anticipating events, thereby also accelerating change. Knowledge of a changing environment by means of sustained environmental scanning is a prerequisite for taking advantage of opportunities and averting threats.

Small business perspective

How to get the public and private sector involved in improving entrepreneurship and growth in the small business sector

South Africa followed a worldwide trend when it introduced a small business ministry to further the development of small businesses in South Africa. It is expected that this ministry will be instrumental in enabling entrepreneurship in South Africa (see also Chapter 2, where entrepreneurship is discussed in more detail). There are serious flaws in the assistance that small businesses currently get from all forms of government, which forms part of the institutional environment of the businesses. Some of the problems relate to the low rate of

total early-stage entrepreneurial activity, the high failure rate of newly formed enterprises, labour laws and regulations that are not conducive to job creation and, in general, low levels of business confidence preventing new business formation. More specific government-related problems include the poor performance of development finance institutions such as the Small Enterprise Finance Agency and the National Empowerment Fund. In the private sector, the big commercial banks are hesitant to lend to high-risk small businesses without surety. The private sector is also contributing. The De Beers group launched a business incubator at its Venetia mine to assist entrepreneurs and enterprises in mining communities. Training covers subjects such as market research, financial management and operational management which eventually results in the development of a viable business plan. This business incubator idea has been rolled out at De Beers mines in South Africa. Furthermore, De Beers is in partnership with Stanford Graduate School in the USA to empower entrepreneurs and owners in Botswana and Namibia.[43]

The National Development Plan (NDP) of South Africa, which must extract the South African economy from its present doldrums, makes provision for about 90 per cent of the 11 million new jobs needed by 2030 to come from the development of small and medium businesses. It is up to public–private partnerships to assist small business to flourish and to defuse the ticking time bomb of unemployment in South Africa. Serious doubts are expressed as to whether South African SMEs are really the growth engine anticipated by the NDP (see Chapter 3 about the underperformance of South African SMEs).

Source: Compiled from information in Chance, T. 2014. On my mind: switch on to small business. Available at http://www.financialmail.co.za/opinion/onmymind/2014/10/09/on-my-mind-switch-on-to-small-business. [Accessed 7 April 2015].

KEY TERMS	
business	international environment
business environment	macro-environment
business functions	market environment
competitive forces	mega-trends
competitors	micro-environment
consumer market	mission
consumerism	mission statement
corporate social responsibility	monetary policy
demographic change	opportunity
economic environment	organisational capabilities
environmental change	physical environment
environmental opportunity	purchasing power
environmental scanning	resources

environmental threat	social environment
environmental variables	suppliers
environmentalism	tangible resources
ethics technological environment	task environment
gross domestic product (GDP)	technological environment
inflation	threat
institutional environment	urbanisation
intangible resources	vision
intermediaries	vision statement

Questions for discussion

Reread the De Beers case study on page 123 and answer the following questions:

1. a.What were the most dramatic changes in the external environment that forced De Beers to reconsider its business model?

   b.Can you think of any other changes in South Africa that might influence De Beers' strategic decision regarding investments in the country?

2.Which market variables would influence the further development of the Venetia Mine near Musina?

3.Perform a SWOT analysis on De Beers.

4.Do you think De Beers still wields some bargaining power in the supply chain as a supplier of diamonds, seeing that its diamond market share has decreased steadily over the years? Motivate your answer.

5.Describe the current competitive situation in the global diamond industry. Refer to Porter's five competitive forces and their impact on the global diamond industry.

6.Using the De Beers example, explain the main differences between an opportunity and a threat in this industry.

Multiple-choice questions

1.South Africa has been negatively affected by the instability in the European Union (e.g. UK (Brexit), Greece, Portugal, Spain and Italy). Businesses, industries and the South African economy as a whole were affected by this. This is an example of a situation in the _________ business environment, which forms part of the _________ environment, over which managers in an organisation have _________ control.

a.national, macro, total

b.global, macro, no

c.global, macro, some

d.global, market, no

2.Which of the following statements about environmental scanning is correct?

a.Environmental scanning is necessary to keep abreast of change, to determine which factors pose threats to stated objectives, and to determine which factors represent opportunities to the business.

b.Environmental scanning is necessary to keep abreast of change, and to determine which factors represent opportunities to promote current objectives, keeping in mind that businesses that systematically scan the environment are usually unsuccessful.

c.Environmental scanning is necessary to impede change, to counteract threats to existing goals, and to determine which factors represent opportunities to promote current goals.

d.Environmental scanning is unnecessary as it is not necessary to keep abreast of change, to determine which factors pose threats to existing goals, or to determine which factors represent opportunities to the business.

3.Which of the following is not one of the five factors determining the nature and intensity of competition in a particular industry?

a.The possibility of new entrants (or departures).

b.The bargaining power of clients and consumers.

c.The lack of technological innovation.

d.The availability or non-availability of substitute products or services.

e.The number of existing competitors.

4.Food, energy and climate, biodiversity and the growing cost of pollution are issues of concern in the _______ environment.

a.technological

b.social

c.physical

d.economic

5.In a developing economy, managers should continually assess technology trends that revolve around the following:

i.mineral technology

ii.medical technology

iii.transport technology

iv.power technology

a.i

b.i,ii

c.

d.i,ii,iii,iv

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CHAPTER 5

Corporate social responsibility

Mari Jansen van Rensburg

The purpose of this chapter

Businesses operate within societies and countries. The impact (good or bad) of their presence and operations on communities and the environment is huge. They exert tremendous financial power and influence upon all sectors of society. Businesses have the power to influence policy, and lobby both government and civil society to further their own, sometimes selfish, interests, maximising profit for their shareholders. They can do so to the detriment of society and the environment. Business also has the power to transform society for the better by acting responsibly in its pursuit of profit. This chapter will explore the role of business as an agent of change for the common good. It will do so by defining and exploring the following interrelated concepts: corporate social responsibility, corporate governance, sustainable development and stakeholder engagement.

Learning outcomes

On completion of this chapter you should be able to:

- explain and define what corporate social responsibility (CSR) is
- explain why a company would consider implementing CSR programmes
- define corporate governance
- explain corporate governance compliance requirements
- define the concept sustainable development
- explain who the stakeholders of a company are
- give reasons why a company should engage with its stakeholders
- describe how a company would go about engaging with its stakeholders
- describe the contribution of CSR to sustainable development.

5.1 Introduction

The development and implementation of corporate social responsibility (CSR) frameworks, policies and practices in companies is an ongoing process. It calls for vision and commitment from the leadership and management of the company – in other words, the board of directors and the senior management team.

CSR has become the latest catchword in business, and most corporates accept that they have a role to play to lessen the burden placed on governments to provide comprehensive social services. However, the commitment and attitudes of corporate leaders differ from those who consider CSR as a distraction from profit maximisation to those who argue that businesses derive enormous benefits from participating in social transformation. For some companies, it is only about compliance compared to other leaders who display true commitment and show impact towards developing their societies. Investec is a shining example of how corporate social responsibility can be entrenched in the core business of an organisation, driving both profits and development.

CASE STUDY: Investec: A responsible corporate citizen

Investec is an international specialist bank and asset manager that provides a diverse range of financial products and services. The company was founded as a leasing company in Johannesburg in 1974 and expanded to serve a select client base in three principle markets, the UK and Europe, South Africa and Asia/Australia. Today the company has a dual listing in London and Johannesburg and is a FTSE 250 company (the FTSE 250 is an index composed of the 101st to the 350th largest companies listed on the London Stock Exchange in terms of market capitalisation). In the almost 40 years of its existence, the company has grown its capital from less than £1 million to the existing £5.4 billion. From the onset, the founders of the company were committed to building a sustainable business, one that has been able to survive and thrive through all conditions, growing earning from £0,16 million in 1981 to £491 million at the end of the 2018 financial year. This business is conscious, not only of their duty to clients and shareholders, but also to employees and the broader community they serve. Investec has a deeply-rooted tradition of active corporate citizenship which has been widely recognised internationally.

Investec's corporate responsibility philosophy is closely guided by their organisational purpose, which is to create sustained long-term wealth. At the heart of their corporate responsibility is a caring approach to their people. The company provides staff with a safe, healthy and stimulating work environment to ensure that they are motivated and equipped to deliver exceptional customer service. Their approach towards corporate social investment is to provide their beneficiaries with a 'hand up' instead of 'hand-out'. As such, they have a focused approach that seeks to make a difference through entrepreneurship and education. The aim of CSI projects is to promote lifelong skills development that can contribute towards building and growing economies of countries in which they operate. In South Africa, the company has contributed towards transformation through several projects, amongst them the Youth Employment Service (YES) programme. This programme, launched in March 2018, aims to find employment for approximately 1200 youth annually. The company also recognises the challenges that climate change presents to the global economy and thus supports activities that either reduce the impact on or prolongs the life of our planet. Investec's commitment towards social responsibility, as well as the achievement and recognition of their efforts, are summarised in the figure on the next page:

We care about our PEOPLE	We care about our COMMUNITIES	We care about our ENVIRONMENT
Attracting and developing a strong, diverse and capable workforce.	Unselfishly contributing to our communities through education and entrepreneurship.	Having a positive enviro impact through our oper business activities.
1,9% spend on learning and development as a % of staff costs for Investec plc (2018)	1,2% spend as a % of operating profit for Investec plc (2018)	6,1% reduction in carbo for Investec plc (2018)
Recognition and Achievements - 2018 Financial Year •Voted second most attractive employer by professionals and fourth by students in South Africa in the 2017 Universum awards. •Investec CEO, Stephen Koseff won the Lifetime Achievement Award presented by the 2018	**Recognition and Achievements - 2018 Financial Year** •Winner of the following Business Charity Awards: »Community Impact 2017 »Business of the Year 2017 •Winner of the National CSR Award for Best Community (Legacy) Project 2017 •Winner of the Bromley by Bow partner of the year award •The South Africa flagship programme, Promaths contributed to 4,8% and 5,0% respectively of the country's total mathematics and science distinctions respectively in the 2017 academic year. Since inception of the programme 12 years ago, Investec	**Recognition and Achi 2018 Financial Year** •Trained 195 frontli consultants on envi social and governa practices in South A the UK •88% of energy len relates to clean ene •12000 children rea through the Coachi Conservation progr 2013

African Banker Awards.	has funded over 7 000 previously disadvantaged learners with 84% either having completed, or are in the process of completing, tertiary education. •Voted South Africa’s eighth most valuable brand •Winner of the Financial Innovation Awards 2017 - Innovation in Sustainability or Social Responsibility Award for The Success programme run in partnership with Arrival Education	•Investec Rhino Life supported the rescu rhino since 2012 •R2,5 million spend initiatives to ensure continuation of busi Cape Town office d 2017/18 drought •The 2 Gresham St won the Chairman’s Corporation of Lond City Awards Schem •The Energy Manag System that covers the UK, Ireland and Islands was certified •The 2 Gresham St Environmental Man System is certified t 14001. •The coordinator of Coaching for Conse programmes at Goo Foundation won a s Eco-logic Award in t ‘Eco-Youth’

Inclusion in world-leading indices (Indices that objectively measure the performance of companies that meet global-rec standards)

Index	2018 Performance	Notes
Carbon Disclosure Project	B	Investec is a member and Investec Asset Management is a sign investor
Code for Responsible Investing in South Africa	Signatory	
Dow Jones Sustainability Investment Index (DJSI) Score out of 100	73	Investec Limited ranked as one of four industry leaders on the D Emerging Markets Index; Investec plc ranked as one of 15 indu on the DJSI World and one of nine in the DJSI Europe indices.
ECPI Index	Constituent	
FTSE4Good Index	Included	
FTSE/JSE Responsible Investment Index Series	Constituent	
MSCI Global Sustainability Index Series - Intangible value assessment rating	AAA	
STOXX Global ESG Leaders Indices	Member	

United Nations Global Compact	Participant	
United Nations Principles for Responsible Investment	Signatory	

Investec's business strategies and decisions are driven by their values and the intention to live in society, and not off it. Clients of this company know that they deal with a sustainable, financially resilient business, which is here for the long term.

Source: Investec. 2018. *Annual Report* 2018. Available at https://www.investec.com/content/dam/investor-relations/financial-information/group-financial-results/2018/FINAL-Investec-DLC-Vol%201-15-June-2018.pdf [Accessed 10 November 2018].

5.2 Introducing corporate social responsibility

5.2.1 What is corporate social responsibility?

Investec publicly declare that making a meaningful contribution to the world in which they operate and live in is at the heart of their values. Their philosophy towards being a responsible corporate citizen is underpinned by making an unselfish contribution to society, nurturing an entrepreneurial spirit, embracing diversity and respecting others.

'I have a basic belief in tomorrow. In the country that is ours. In the power of possibility. Investec provides a platform to really make a difference.' Fani Titi, Investec Group Co-CEO.[1]

There has been increased pressure on business leaders to take a stand on social issues and environmental issues. Today, consumers expect to hear what CEOs and companies think about issues that affect all of society including inequality, globalised trade, social tensions, climate change, population growth, ecological overshoot, geopolitical tensions, radical transparency and rapid technological and scientific advancement.[2] Corporate CEOs have the clout and credibility to lead the action and change required to safeguard our planet and address socio-economic issues on which governments lag.[3] In 2017, the world's 500 largest companies generated $30 trillion in revenues, $1,9 trillion in profits and employed 67,7 million people worldwide. Walmart was ranked first in terms of annual revenue on the 2018 Fortune Global 500 list. This company employed 2 300 000 people and recorded revenue of $500,3 billion.[4] To put this in perspective, Walmart's revenue is in excess of the government revenue of major global economies including Australia, South Korea and India. The company's revenue was more than five times that of the $92,38 billion earned by South Africa in 2017.[5]

The reality is that corporations exert tremendous power upon the world. The financial wealth and economic clout of such major players allow them to use their power and influence to contribute to the common good of markets. They can do so through **partnerships** with government, business, communities or by themselves, providing equitable and safe job opportunities, investing in small and medium enterprises (SMMEs) through their supply chains, and building infrastructure, as Investec does. Industry can even develop new technologies for energy efficiency or products to provide the poor with access to markets. Corporations can also lessen their impact on societies and the environment, or even contribute to social development. Many companies live up to society's expectations to become part of the solution. Vodacom has, for example, committed to social transformation in response to the call by

the South African government for wider economic inclusion as illustrated in the box that follows.

CASE STUDY: Vodacom[6]

In response to the high levels of inequality, unemployment and poverty in South Africa, Vodacom has pledged its commitment to further broaden access to digital services. As such, the company includes a clear commitment to removing barriers to digital access, and to deliver the significant societal benefits associated with improved connectivity in their Vision 2020. Vodacom furthermore pledged to play 'a transformative role in the provision of financial services, education, healthcare and agriculture, and to demonstrate leadership in promoting Broad-Based Black Economic Empowerment (B-BBEE) in South Africa'. Their existing initiatives to accelerate socio-economic transformation include:

- Substantial investment in extending networks into rural areas across markets;
- Promoting commercially viable mobile agricultural solutions through their Connected Farmer platform, and delivering measurable education and health benefits through mobile data initiatives;
- The Siyakha platform offers a zero-rated health, education and career portal for low-income consumers in South Africa;
- Investments in enterprise development, preferential procurement, skills development and employee diversity; and
- A retail transformation strategy that encourages greater 'black' ownership of their franchise channel.

However, such power could also be exploited and result in real harm to human health, human society, political governance and the natural environment. The challenge for major corporations with global clout is to recognise and act on the mutual interdependence between nations, societies and firms. **Corporate social responsibility** (CSR) deals with how business organisations can meet essential needs without dishonouring community values.

Definitions of CSR vary by, amongst other things, the different practical orientations of corporations towards their responsibilities. Different companies also give varying emphasis to different aspects of CSR (for example, community involvement, socially responsible products and processes, and socially responsible employee relations) to realise their business objectives. The general consensus is that CSR is an umbrella concept that recognises the following points:

- Companies have a responsibility for their impact on society and the natural environment. This responsibility may extend beyond legal compliance and the liability of individuals.
- Companies have a responsibility for the behaviour of others with whom they do business (for example, within supply chains).
- Companies need to manage their relationship with wider society, whether for reasons of commercial viability or to add value to society.

The King III Report[7] provides a broader definition of the responsibilities of corporations (not limiting the scope to the social aspect only): 'Corporate responsibility is the responsibility of the company for the impacts of its decisions and activities on society and the environment, through transparent and ethical behaviour that:

- contributes to sustainable development, including health and the welfare of society;
- takes into account the legitimate interests and expectations of stakeholders;
- is in compliance with applicable law and consistent with international norms of behaviour; and
- is integrated throughout the company and practiced in its relationships.'

5.2.1.1 Corporate citizenship and corporate social investment

Some literature uses the terms 'corporate citizenship', 'corporate social investment' and 'corporate social responsibility' interchangeably. Although corporate social responsibility and corporate citizenship both refer to business's conduct in society, the former focuses solely on the responsibility aspect of business while the latter focuses on business being a social player by virtue of both its rights and its responsibilities as a citizen. Some explanation of why the term 'corporate social responsibility' is preferred above the term 'corporate citizenship' in this book is given below. Note that corporate social investment refers only to one very specific aspect of corporate social responsibility.

The term '**corporate citizenship**' 'is the recognition that the organisation is an integral part of the broader society in which it operates, affording the organisation standing as a juristic person in the society with the rights but also the responsibilities and obligations. It is also the recognition that the broader society is the licensor of the organisation.'[8] Corporate personhood means that corporates are granted constitutions rights. These rights and responsibilities include the right to govern internal affairs, the right to enter into contracts, the right to hold assets, the right to hire, and the right to sue and be sued.

Corporate social responsibility, with its focus on the responsibilities of corporations, is therefore a preferred term to corporate citizenship.

Critical thinking

Pioneer Foods: Nourishing the lives of South African children.

Pioneer Foods is one of South Africa's largest producers and distributors of branded food and beverage products. As part of their commitment to their community, the company established the 'School Breakfast Nutrition Programme'. This programme ensures that more than 26 000 learners from disadvantaged communities across South Africa have at least one nutritious meal per day. The impact of this programme is widely recognised and has had a positive impact on school attendance, learner performance and health.[9]

Do you think that Pioneer Foods benefits from this initiative, or should this be considered an unrecoupable expense?

It is clear that Pioneer Foods takes responsibility for giving back to the community beyond what is legally expected. The 'School Breakfast Nutrition Programme' initiative also signals the company's commitment to the communities it serves by offering at least one nutritious meal to those who cannot afford it.

While companies may donate substantial amounts of money to worthy causes and community-based projects, CSI does not refer to a company's contribution to society through its **core business activities** for example, the creation of employment and training opportunities or local business development. Neither does it refer to a company's contribution through its engagement in public policy. Over the past 20 years, South African companies have contributed an estimated R137 billion to social development. The estimated CSI expendidure in 2017 was R9,1 billion.[10] Gone are the days where the social responsibility of business was to increase its profits; instead it is now expected that organisations operate in the triple context of the economy, society and the environment.

5.2.2 Cannibals with forks: The triple bottom line

Best-selling author and green guru John Elkington published a book entitled *Cannibals with forks: The triple bottom line of 21st century business* in 1998.[11] The title was inspired by poet Stanislaw Lec who asked the question: 'Is it progress if a cannibal uses a fork?'

Elkington made a compelling argument that businesses could expand their life expectancy by using sustainability's 'three-pronged fork', or the triple bottom line. Indeed, he argues that future market success often depends on a business's ability to satisfy not just the traditional bottom line of profitability, but that companies are also required to focus on environmental quality and social justice. In this section, we will review the triple bottom line, a term coined by Elkington. This is an important concept as businesses operate in an environment in which the planet, people and profit are inextricably intertwined. To illustrate this philosophy practically, imagine being asked to provide investment advice about the following three companies described by their CEOs as follows:

Company 1: Our company is known for its green approach, meeting rigorous environmental standards in terms of infrastructure, manufacturing and operations. Producing environmentally friendly products is more expensive but, given the international emphasis on environmental sustainability, consumers are willing to pay a premium when buying these products. I believe that the decline in market share is temporary and that it will recover along with the country's economy. I am, however, concerned about rumours of possible retrenchments and low staff morale. Perhaps if we cut our advertising budget, we could postpone this.

Company 2: Staff is our priority and we are proud to announce that we won the Employer of the Year award two years ago. Happy employees are productive employees and, as such, we provide a child-care facility, a state-of-the-art restaurant and a caring environment. The past few years have been difficult with the economic crunch. Let's face it: consumers tend to cut back on luxury consumer goods. So, perhaps we need to lower our manufacturing and product standards, but we will never compromise our commitment to our staff.

Company 3: Being in the mineral sector, we know that we offer a world-class product at below-industry costs. We are, however, very disappointed with the attitude of the local community and labour market. One would expect that in a country with such a high unemployment rate, low-skilled workers would be more appreciative of being gainfully employed. We have also invested in the community in terms of creating jobs and supporting local businesses and schools, and we realise that concerns about pollution are valid. Then again, we will rehabilitate exhaustive mines. We also have health and safety programmes, so we don't know what all the fuss is about.

Sadly, the business interests of the above companies clearly indicate that not one is embracing the triple bottom line sustainably. The idea behind the triple bottom line is that a company's ultimate success or health can, and should, be measured against its financial bottom line as well as its social/ethical and environmental performance. It is therefore expected, and required, that companies honour their obligations to stakeholders and behave responsibly.

The fundamental changes to business and society calls for all organisations and governments to conduct business in a sustainable manner. It is a reality that organisations and individuals are using natural assets faster than nature is regenerating them. In addition, continued population growth on the African and Asian continents creates tension between what humanity needs and what the planet can provide. Society expects business leaders and governments to become part of the solutions and not to shy away from commitments to achieve the United Nations Development Goals, the African 2063 Agenda and the South African National Development Plan 2030.

Companies listed on the Johannesburg Stock Exchange must integrate sustainability reporting with financial reporting. South Africa is one of the few emerging economy

markets that requires formal sustainability reporting. However, despite clear reporting guidelines, South African companies and state-owned enterprises dominate the media when it comes to accounting and business-related scandals; think about the report on state capture, the Guptas, Steinhoff, KPMG and VBS to list only a few. Some of these stories read like film scripts. For example, the description on the back cover of the book 'Steinhoff: Inside SA's Biggest Corporate Crash', written by James Brent Styan, reads as follows:[12]

> On the morning of Tuesday 5 December 2017 the Steinhoff Group was worth R193 billion. Twenty-four hours later, more than R117 billion of its market value had been wiped out. The Steinhoff empire, built up over 50 years into an international business giant, had crumbled overnight.
>
> Markus Jooste, Steinhoff's flashy CEO, resigned and has since dodged an avalanche of accusations and scandals involving luxury homes for a blonde mistress, racehorses, allegations of fraud and a life of extravagance.
>
> What exactly happened? What is Steinhoff, who is Markus Jooste, and how does it all tie in with the so-called 'Stellenbosch Mafia'? Where do business tycoon Christo Wiese, Shoprite and Pepkor fit in, and where is the pensioners' money?
>
> Source: Reprinted with permission from LAPA Publishers.

Organisations and individuals can no longer escape the consequences of social and environmental injustices as it becomes almost impossible to conceal secrets. Indeed, social media and sophisticated analytics are creating a world characterised by radical transparency. Stakeholder expectations have also changed and the Millennials (those born since 1980) have shown that they are more concerned with the global environmental crunch than with the financial crisis. Hence, organisations need to create value in a sustainable manner, 'making more but with less'.[13]

Judge Mervyn King, said: ... 'the duty of care has become both more complex and more necessary. No governing body today can say it is not aware of the changed world in which it is directing an organisation. Consequently, a business judgement call that does not take account of the impacts of an organisation's business model on the triple context could lead to a decrease in the organisation's value.'[14]

In this context, it should be noted that sustainable organisations and societies typically generate and live off interest rather than depleting their capital. Capital includes natural resources (i.e. minerals, water and air), human and social assets (from worker commitment to community support) as well as economic resources (i.e. legal and economic infrastructure). In short, the triple bottom line advocates that a company's ultimate worth should be measured in financial, social and environmental terms. These terms should respond to all stakeholders' legitimate claims.[15] As a result, the **triple bottom line (TBL)** metaphor has been incorporated across the world to guide corporate reporting. Key examples include the European Union's directive on environmental, social and governance (ESG) reporting, the United Kingdom's strategic report, the context of reports filed with the United States Securities and Exchange Commission, the Operating Financial Review in Australia and the listing requirements of several stock exchanges, including the JSE.[16] These reporting frameworks have changed traditional focus on financial reporting to include dimensions of social and environmental performance. The TBL dimensions are also commonly called the three Ps: people, planet and profit.[17] If companies pay lip service to social responsibility – even Steinhof had an exhaustive code of ethics and principles – the outcome could be devastating. Conversely, companies embracing the triple context lay a solid foundation for a sustainable future.

In the context of Africa, the notion that emphasises the interdependence between organisations and societies is underpinned by the concept of *Ubunto* or *Botho*, captured by the expressions *uMuntu ngumantu ngabantu* and *Motho ke motho ka batho* - I am because you are; you are because we are. These concepts imply that the common purpose in all human endeavour should be to serve humanity. In line with this ethos, organisations are also required to take responsibility for their activities and outputs. These obligations to society are set out in the South African Companies Act. Section 7, for example, states that the purpose of the act includes 'to promote compliance with the Bill of Rights as provided for in the Constitution' and it 'reaffirms the concept of the company as a means of achieving economic and social benefits.'[18]

5.2.3 CSR in contemporary business management

Although reporting frameworks include CSR, the focus should extend beyond compliance, reporting and publicity. Executives should encourage a culture of corporate social responsibility and become influencers in advancing social and environmental challenges. The focus of CSR should also be aligned to current discourse to address issues that matter to employees, customers and communities. The discourse in 2018 focused on the themes listed below:[19]

Workplace harassment and inequality: Reading the 'Whistle blowing essay' by Susan Fowler about sexism and harassment during her time at Uber and following the #MeToo movement it becomes clear that sexual harassment and gender inequality occur in even the most progressive companies and societies. Various initiates have been implemented in South Africa to prepare females for senior management and leadership roles, and the results have been encouraging, showing year-on-year growth. Findings in the 2018 Grant Thornton International Business Report suggest that 29 per cent of senior roles in South Africa are filled by women. However, one in five local businesses still have no women at all in senior positions. These businesses are yet to realise the advantages of diversity and need to create inclusive cultures in which a wide range of voices are listened to. Addressing gender inequality should be about behavioural changes instead of ticking checkboxes.[20]

Diversity conversations: Although gender inequality is often a leading topic, diversity considerations should be expanded. Diversity should be extended beyond gender and race to include different cultures, languages, ages, sexual orientations, disabilities, backgrounds and experience. A diverse workforce can improve performance as research has shown that heterogeneity promotes creativity and heterogeneous groups have been shown to produce better solutions to problems and a higher level of critical analysis.[21] However, embracing diversity requires mutual respect and understanding beyond mere compliance to equal treatment policies and scorecard targets.

Corporate activism: Prominent business leaders issue reactive statements on everything from land reform to state capture. As illustrated in the Vodacom case study, it is expected that companies will take more focused action by designating social or policy areas where they can make the most impact or devote resources as part of proactive initiatives. Brave leaders like Sipho Pityana, for example, openly expressed his dissatisfaction with the ANC leadership. In an interview aired on eNCA in 2016, Pityana called for the President to resign – 'He [Zuma] should resign as the president of the country and that's what accountability is all about. It is not possible that they can't see that the country is going through the kind of mayhem and mess it's going through. It is not possible that they can't see the ANC is going through what it is going

through'.[22] Pityana's efforts as convenor for the 'Save SA' campaign have been noted and in June 2018 he was elected to lead Business Unity SA.[23]

From disaster recovery to climate resilience: No company is immune from climate change and companies are increasingly investing more resources into preventing, mitigating and adopting an attitude of climate resilience rather than just planning recovery. In 2018, Cape Town was on the verge of becoming the first major urban centre to run out of water. Cape Town narrowly averted disaster through drastic civic water conservation campaigns initiated and supported by local government, business and communities. Stakeholders worked closely together to reduce water consumption. Residents had to halve their consumption with suburban restrictions of 50 litres a day per person; local businesses and government invested in desalination plants, wastewater treatment units and groundwater-extraction projects; and business had to adapt. Top-tier restaurants served food on paper plates, salons requested clients to wash their hair prior to appointments, hotels removed bath plugs to encourage guests to shower rather than bath. These are only some of the reactions. In facing a future with ecological limits many businesses are rethinking their impact on the environment and are facing tough decisions over sharing scant resources.[24]

Higher standards for suppliers: Increasingly, large companies use their power as customers to drive improvements in responsible business practices through their supply chains. As a client, corporates hold suppliers accountable for business ethics, environmental performance and human rights issues. Association with suppliers may impact on corporate reputations and hence suppliers are evaluated on more than the services they deliver or products they produce. If suppliers are implicated in, or associated with unethical conduct it often has a direct impact on their performance. Consider, for example, the case of KPMG. Following heavy criticism over its work for South Africa's controversial Gupta family and the collapsed lender VBS, 20 listed clients ended their professional relationship with KPMG between 2017 and 2018. South Africa's Auditor-General also barred KPMG from government work, citing 'significant reputational risks' from being associated with the firm.[25]

Prioritising privacy and data protection: Following looming treats of cyber-attacks, many reported cases of identity theft and widespread cybercrimes, companies are required to safeguard clients' rights to privacy. South Africa has established laws protecting data privacy (i.e. the Protection of Personal Information Act (No. 4 of 2013)) but there is currently no legislation in effect which compels a business to disclose data breaches to any authority or to the persons affected. The leaks of personal information have highlighted the need for organisations to have robust cyber-security systems. As part of their responsibility to protect clients, corporations should not collect data that is not relevant. Businesses also need to secure permission to use collected data if it extends the reason for collection. Companies furthermore need to ensure that any data collected is highly secured and that only need-to-know personnel have access. Finally, staff require training on how to avoid phishing scams and malicious software downloads.[26]

Today, CSR is transforming from an approach that focused on corporate social investment in charitable causes and promotional actions to become an integrative approach that is more strategic and transformative in nature. Business leaders are also expected to take on a responsibility to create a more sustainable future. Take, for example, Elon's Musk's vision to 'help expedite the move from a mine-and-burn hydrocarbon economy toward a solar electric economy' through Tesla enterprises. This can only be done if leaders change their way of thinking and doing. Cherished

ideologies, high-impact lifestyles and selfish values need to be replaced by transformational leadership committed to delivering a social purpose through business.[27]

The business rational for CSR varies, however, most CSR programmes are driven by a combination of reasons.

5.2.3.1 Social drivers

No company would wish to have the reputation of being socially irresponsible. It is desirable for an organisation or an activity to be thought of as socially responsible. Some consumers prefer socially responsible products and services, and employees increasingly choose to work for companies with a reputation for being socially responsible. Mainstream investment funds and stock exchanges are addressing CSR objectives. Primary mechanisms for these are the Dow Jones Sustainability Index in New York, the FTSE4Good in London and, more recently, South Africa's FTSE/JSE Responsible Investment Index Series.

Civil society organisations and other groups have worked with companies and governments to develop voluntary standards or guidelines as to how socially responsible corporations should act. Examples of these guidelines include the Organization for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, United Nations (UN) Guiding Principles, Global Reporting Initiatives, ISO 26000 - Social responsibility, Voluntary Principles on Security and Human Rights, ten principles of the United Nations Global Compact, the Equator Principles, the Extractive Industry Transparency Initiative (EITI), and the UN Principles for Responsible Investment.

Thus, it becomes obvious that many companies engage in CSR because society expects it of them. The companies want to protect their reputation by meeting these societal expectations.

5.2.3.2 Governmental drivers

Most governments enforce local and national legal systems with which companies must comply in order to operate in that country. These systems include legislation about companies, labour relations and environmental management. Many governments also show considerable interest in encouraging business involvement in social issues through CSR. The government of the United Kingdom even has a cabinet minister for CSR, and a variety of policies and initiatives to coax corporations to be more socially responsible. Governments can also facilitate CSR through the provision of organisational support. This can even be extended to subsidies for CSR organisations and activities. Governments may also introduce so-called soft regulation to encourage corporations to be more socially responsible. Legislation encourages corporate behaviour that is socially and environmentally responsible, as well as ethical reporting.

In CSR, compliance stretches beyond the letter of the law to the spirit of the law. If a company complies only with the letter of the law, this means it is doing the bare minimum to avoid sanction. It is possible to comply with the letter of the law in such a way that the objectives of the legislation are not achieved. Complying with the spirit of the law means that the company is doing what can be reasonably expected to further the objectives of the legislation.

5.2.3.3 Market drivers

CSR does not only represent costs for companies. It can also result in various advantages such as reduced costs or increased revenues. Companies can reduce cost through CSR by:

- avoiding fines;
- avoiding legal costs;
- using resources efficiently – for example, reducing use of energy or paper means lower energy or paper costs;
- using alternative raw material sources, such as recycled materials;
- reducing recruiting costs;
- increasing staff retention; and
- reducing the cost of capital.

Companies can also increase revenue through CSR by:

- developing new products or services – for example, carbon credit trading;
- growing markets for services through general programmes such as job creation and social development, or more specific interventions such as bridging the digital divide;
- improving access to markets – for example, government procurement;
- avoiding boycotts; and
- exploiting the CSR premium (we have already referred to consumers who prefer to buy products and services from companies that are socially responsible; some consumers are prepared to pay a premium for products and services that they consider socially responsible).

Many companies see CSR as part and parcel of their competitive edge. By integrating economic strategies with CSR strategies, they can achieve a competitive advantage. In other words, companies receive a financial reward for addressing social, environmental and economic problems.

The **business case** plays a dominant role in motivations for companies to engage in CSR. What, however, happens to social, economic and environmental issues for which a business case cannot be made? There are also many factors such as the company's visibility, location, size, ownership structure, and the sector and market segments in which it operates that influence whether there is a business case to be made. Despite the many claims made on its behalf, there is also no empirical evidence for the business case for CSR.

5.2.3.4 Ethical drivers

Generally speaking, **ethics** is about deciding between right and wrong conduct. **Business ethics** is a subset of ethics that focuses on deciding between right and wrong in the workplace and in business generally.

Responsibility can be seen as an ethical value. Hence, it goes beyond individual considerations and is oriented towards the common good. Some thinkers might see the market system as a subsystem to the social system, and thus believe that enterprises have a social responsibility as well as a legal and economic responsibility. Companies might feel ethically responsible for damage resulting from production – for example, harm inflicted on the environment. They might also feel responsible for the communities in which they operate, and thus do more than simply comply with the law, especially in countries with inadequate bureaucratic regulation. For some companies, CSR is the right thing to do.

The ethical responsibility of a business does not only apply to external damage. It also applies to responsible business dealings and conduct in the workplace. However, there is much confused and incorrect thinking about business ethics, as illustrated in the box that follows.

Ten myths about business ethics

Ethics in the workplace is about prioritising moral values and ensuring that behaviours are aligned with those values. Myths about business ethics abound. Some of these myths arise from general confusion about the notion of ethics. Other myths arise from narrow or simplistic views of ethical dilemmas. Here are ten common myths about business ethics. Each myth is followed by an explanation that debunks it.

Myth 1: Business ethics is more a matter of religion than management. Diane Kirrane asserts that 'altering people's values or souls isn't the aim of an organisational ethics program – managing values and conflict among them is'.

Myth 2: Our employees are ethical, so we don't need to pay attention to business ethics. Most of the ethical dilemmas faced by managers in the workplace are highly complex. Kirrane mentions that when the topic of business ethics comes up, people are quick to speak of the golden rule of honesty and courtesy. But when presented with complex ethical dilemmas, most people realise there's a wide grey area to deal with when trying to apply ethical principles.

Myth 3: Business ethics is a discipline best led by philosophers, academics and theologians. Lack of involvement of leaders and managers in business ethics literature and discussions has led many to believe that business ethics is a fad or a movement, having little to do with the day-to-day realities of running an organisation. They believe business ethics is primarily a complex philosophical debate or a religion. However, business ethics is a management discipline with a programmatic approach that includes several practical tools. Ethics management programmes have practical applications in other areas of management areas as well.

Myth 4: Business ethics is superfluous. It only asserts the obvious: 'Do good!' Many people feel that codes of ethics or lists of ethical values to which an organisation aspires are superfluous because they represent values to which everyone should naturally aspire. However, the value of a code of ethics to an organisation is its priority and focus about certain ethical values in that workplace. For example, it's obvious that all people should be honest. However, if an organisation is struggling with issues of deceit in the workplace, prioritising honesty is very important, and honesty should be listed in that organisation's code of ethics. Note that a code of ethics is an organic instrument that changes with the needs of society and the organisation.

Myth 5: Business ethics is a matter of the good guys preaching to the bad guys. Some writers do seem to claim the moral high ground while lamenting the poor condition of business and its leaders. However, people who are well versed in managing organisations realise that good people can take bad actions, particularly when stressed or confused. (Stress and confusion do not excuse unethical actions – they are reasons.) Managing ethics in the workplace includes all of us working together to help each other remain ethical and to work through confusing and stressful ethical dilemmas.

Myth 6: Business ethics is the new policeperson on the block. Many people believe business ethics is a recent phenomenon because of increased attention to the topic in popular and management literature. However, business ethics was written about by Cicero 2 000 years ago. Business ethics has been given more attention recently because of the social responsibility movement that started in the 1960s.

Myth 7: Ethics can't be managed. Actually, ethics is always managed, but, too often, it is managed indirectly. For example, the behaviour of the organisation's founder or current leader is a strong moral influence on the behaviour of employees in the workplace. Strategic priorities (profit maximisation, expanding market share, cutting costs and so on) can be very strong influences on morality. Laws, regulations and rules directly influence behaviours to be more ethical, usually in a manner that improves the general good and/or minimises harm to the community. Some people are still sceptical about business ethics, believing that you can't manage values in an organisation. Donaldson and Davis note that management is, after all, a value system. Sceptics might consider the tremendous influence of several 'codes of ethics' such as the Ten Commandments in Christianity or the Constitution of the United States. Codes can be very powerful in smaller organisations as well.

Myth 8: Business ethics and social responsibility are the same thing. The social responsibility movement is only one aspect of the overall discipline of business ethics. Corporations also need to consider how business ethics can be managed. Writings about social responsibility often do not address practical matters of managing ethics in the workplace – for example, developing codes, updating policies and procedures, approaches to resolving ethical dilemmas, and so on.

Myth 9: Our organisation is not in trouble with the law, so we're ethical. It is possible to be unethical yet operate within the limits of the law. Examples include withholding information from superiors, fudging on budgets and constantly complaining about others. However, breaking the law often starts with unethical behaviour that has gone unnoticed. The 'boil the frog' phenomenon is a useful parable here: if you put a frog in hot water, it immediately jumps out. If you put a frog in cool water and slowly heat up the water, you can eventually boil the frog. The frog doesn't seem to notice the adverse change in its environment.

Myth 10: Managing ethics in the workplace has little practical relevance. Managing ethics in the workplace involves identifying and prioritising values to guide behaviours in the organisation, and establishing associated policies and procedures to ensure those behaviours are conducted. This could be called values management. Values management is also important in other management practices – for example, managing diversity, Total Quality Management and strategic planning.

Source: Free Management Library. n.d. Ten Myths About Business Ethics. Available at http://managementhelp.org/ethics/ethxgde.htm#anchor29959. [Accessed 01 November 2018]. © Carter Mc-Namara, MBA, PhD, Authenticity Consulting, LLC. Reprinted by permission of Dr Carter McNamara.

The discussion on CSR has alerted us to the fact that corporations are classified as legal entities or corporate citizens who have certain rights and responsibilities. As corporations are recognised by law, they can enter into contracts and do business in selected markets. They can own assets and owe money to others and can sue and be sued. It is also expected that companies would conduct themselves responsibly towards stakeholders and use their operating environment sustainably. Yet, it remains the responsibility of people to make decisions that will ensure that the interests of the company are looked after. In the next section, we will consider the leadership tasked with making these decisions.

5.3 Corporate governance

5.3.1 Corporate governance defined

The word governance is derived from Latin *gubernare*, which means to steer. Good governance is thus essentially about ethical and effective leadership. To be ethical, leadership should be exemplified by integrity, fairness, accountability and transparency. To be effective, governing bodies need to achieve strategic objectives and positive outcomes. Ethical and effective leadership should complement and reinforce each other to achieve an ethical culture, good performance, effective control and legitimacy.[28] Governance thus refers to the way in which an organisation or group makes decisions about how to manage its affairs. Essentially, corporate governance is the system by which companies are managed and controlled. It also refers to the relationship between those who govern and those who are governed.

The board of directors is a group of people assembled to lead and control the company so that it functions in the best interests of its shareholders. The rights and responsibilities of directors are conferred on them by various acts, the articles of association of the company and common law. A director stands in a fiduciary

relationship to the company (the term 'fiduciary' is derived from the Latin *fiduciarius*, meaning 'of trust') and is bound by fiduciary responsibilities. The board is the focal point of the corporate governance system. Management is primarily responsible for implementing strategy as defined by the board.

To enable the board to discharge its duties and responsibilities, as well as fulfil its decisionmaking process effectively, it may delegate some of its functions to board committees. However, delegating authorities to board committees or management does not in any way reduce the board's collective accountability and responsibility for the performance and affairs of the company.

Boards are composed of both **executive** and **non-executive** directors. Executive directors are members of the management team who are appointed to the board. They are full-time employees of the company. Executive directors have a fiduciary role as directors of the company on the one hand. They also have a role as senior management. Non-executive directors are not involved in the day-to-day operation of the business of the company and do not receive any remuneration other than their director's fees. They are independent of management and should be free from any significant business or other relationship with the company that could materially hamper their independence. Non-executive directors should be able to provide independent judgement on issues facing the company, assist in objectively monitoring and reviewing management's performance against budget and company strategy, and ensure adequate protection of the interests of the company where these may conflict with the personal interests of the (executive) directors. An independent director is a non-executive director who has no existing or prior business, employment, consultancy or other relationship with the company.

The primary roles and responsibilities of governing bodies are depicted in Figure 5.1. As a governing body, it is the board's responsibility to set and review an organisation's strategic direction, approve strategic plans and policies, ensure organisational accountability and finally, monitor and evaluate strategic execution. Figure 5.1 illustrates the roles and responsibilities of governing bodies.

Figure 5.1 Primary roles and responsibilities of governing bodies

Source: Institute of Directors Southern Africa. 2016. The King IV Report on Corporate Governance™ in South Africa 2016 ("King IV Report"). Copyright and trade marks are owned by the Institute of Directors in Southern Africa and the IoDSA website link is http://www.iodsa.co.za/?page=AboutKingIV p. 21.

There are two separate and very distinct tasks at the top of every company that must be performed by two separate individuals to ensure a balance of power and authority. The chairman of the company is responsible for the running of the board and the chief executive officer is responsible for running the company's business. It is also recommended (and sometimes required) that the chairman be an independent non-executive director.

5.3.2 Corporate governance compliance

The governance of corporations can be on a statutory basis (regulated by law), or as a code of principles and practices, or a combination of the two. The United States of America has, for example, chosen to codify a significant part of its governance in an Act

of Congress known as the Sarbanes-Oxley Act (SOX). This statutory regime is known as 'comply or else', and there are legal sanctions for non-compliance. In contrast, the 56 countries in the Commonwealth, including South Africa and the 27 states in the European Union (including the United Kingdom), have opted for a code of principles and practices on a 'comply or explain' basis, in addition to certain governance issues that are legislated. King IV changed the South African approach to 'comply and explain'. Such explanation is done through integrated reporting as discussed later in this chapter. There are numerous frameworks, standards and codes available to guide companies towards good governance. Examples include the OECD Principles of Corporate Governance and the four **King Committee reports on corporate governance**. There is always a link between good governance and compliance with the law. Regardless of whether countries have adopted the 'comply or else', or 'comply and explain' approach, good governance is not something that exists separately from the law. However, if there is conflict between legislation and a governance framework, law prevails.

Voluntary governance codes, such as the King IV report, recommend leading practices of governance. Although adherence is voluntary, it may trigger legal consequences as courts would consider all relevant circumstances to determine appropriate standards for conduct for those charged with governance duties. In this way provisions contained in widely adopted codes become part of the common law and adherence, albeit not legislated, may invoke liability.[29]

It is, however, impossible to stop dishonesty or to legislate morality in companies. Morality, whether corporate or individual, is driven by a certain mindset. In this sense, corporate governance is essentially about leadership that is transparent. The leadership of a company must be seen to be answerable and accountable to that company's stakeholders.

5.3.2.1 Primary principles of good governance

Good governance practice is established over time and governance codes recognise that a 'one-size-fits-all approach' is not suitable given the differences in operational scope, size and type of organisations. The focus is thus shifted from mindless compliance to mindful application, which harnesses the benefits of corporate governance. The King Reports provide organisations with a model to guide their approach to governance. Each of these reports includes outcomes, principles and practices. These guidelines embody the ideal and leading benchmarks to which many organisations aspire on their journey to good governance. The codes are therefore meant to be scaled in accordance with consideration to the organisation's abilities and resources. The 17 principles of good corporate governance in King IV include:[30]

The governing body should:

1. Lead ethically and effectively.
2. Govern the ethics of the organisation in a way that supports the establishment of an ethical culture.
3. Ensure that the organisation is and is seen to be a responsible corporate citizen.
4. Appreciate that the organisation's core purpose, its risks and opportunities, strategy, business model, performance and sustainable development are all inseparable elements of the value creation process.
5. Ensure that reports issued by the organisation enable stakeholders to make informed assessments of the organisation's performance and its short, medium and long-term prospects.

6.Serve as the focal point and custodian of corporate governance in the organisation.
7.Comprise the appropriate balance of knowledge, skills, experience, diversity and independence for it to discharge its governance role and responsibilities objectively and effectively.
8.Ensure that its arrangements for delegation within its own structures promote independent judgment and assist with balance of power and the effective discharge of its duties.
9.Ensure that the evaluation of its own performance and that of its committees, its chair and its individual members, support continued improvement in its performance and effectiveness.
10.Ensure that the appointment of, and delegation to, management contribute to role clarity and effective exercise of authority and responsibilities.
11.Govern risk in a way that supports the organisation in setting and achieving its strategic objectives.
12.Govern technology and information in a way that supports the organisation setting and achieving its strategic objectives.
13.Govern compliance with applicable laws and adopt non-binding rules, codes and standards in a way that supports the organisation being ethical and a good corporate citizen.
14.Ensure that the organisation remunerates fairly, responsibly and transparently so as to promote the achievement of strategic objectives and positive outcomes in the short, medium and long term.
15.Ensure that assurance services and functions enable an effective control environment, and that these support the integrity of information for internal decision-making and of the organisation's external reports.
16.Adopt a stakeholder-inclusive approach in the execution of its governance role and responsibilities that balances the needs, interests and expectations of material stakeholders in the best interest of the organisation over time.
17.Ensure that responsible investment is practiced by the organisation to promote the good governance and the creation of value by the companies in which it invests.

These principles embody the aspirations of the journey towards good corporate governance. Principles build on and reinforce each other and hold true across all organisations. Each of these principles are accompanied by a set of practices which set a good foundation for governance. However, corporate governance principles and practices are dynamic, and evolve. The application and implementation of these principles differ for different entities, and organisations are thus expected to disclose how they have adapted these principles to stakeholders. The governance of risk is also addressed in terms of the board and management's responsibilities for risk assessment, management, response, monitoring, assurance and disclosure. Other governance aspects reviewed in the report are the governance of information technology; compliance with laws, rules, codes and standards; internal audits; governing stakeholders' relationships; and integrated reporting and disclosure.

5.3.3 How does corporate governance relate to CSR?

The impact of corporate misconduct and unlawful acts is demonstrated in the box on page 179. Such scandals are not only harmful to the reputation of corporations competing globally for customers and talents, but could also result in the demise of the

corporation. They also harm investors, shareholders, employees and the public, who are all affected by failures in corporate governance. CSR recognises the responsibility of corporations for their impact on society.

Instead of only asking questions about shareholder value (the bottom line) and the pay packets of 'fat-cat' directors, boards should also ask questions like: What is business for? What are our core values? Who should have a say in how companies are run? What is the appropriate balance between shareholders and stakeholders? Which balance should be struck at the level of the triple bottom line?

Sir Adrian Cadbury redefined corporate governance in this sense as 'concerned with holding the balance between economic and social goals and between individual and communal goals […] the aim is to align as nearly as possible the interests of individuals, corporations and society'.[31]

If corporate governance is a leadership challenge and if CSR has evolved as an aspect of good corporate governance, it follows that the chairperson and his or her board, who are the focal point of the corporate governance system, should govern CSR programmes. They have to monitor risks and opportunities, engage with stakeholders, formulate policies and strategies to be implemented, and monitor this implementation. Management is responsible for implementing and managing the CSR programme. In this sense, the optimum structure of CSR mirrors the structure relating to financial governance: a separation between the day-to-day management of these issues, on the one hand, and monitoring and assurance (the independent checking of performance) on the other hand.

A CSR programme should be embedded in a specific board-level structure, such as a CSR committee. This committee should have a good understanding of CSR. There are three ways in which the board and the CSR committee can determine how to establish the corporate policy for CSR:

- A **values-based system**, in which the CSR policy is aligned with the company's own vision, mission, values and guiding principles, is used when a company addresses CSR in a proactive manner.
- A **stakeholder-engagement process**, which allows stakeholders to determine what they want from the company and what they consider to be the issues and culture of the company, is a reactive approach.
- A **combination of both values-based and stakeholder-engagement processes**, which often emerges from an original emphasis on a values-based approach but develops in a combination approach when the company moves from setting its own objectives aligned with its values to involving its stakeholders. This allows the company to ensure that its strategy satisfies its own needs as well as the needs of its stakeholders.

The policy statement of the CSR committee should cover the company's vision, commitment, goals and targets for CSR. Once the board and the CSR committee have established a policy and strategy for CSR, it will need to be implemented throughout the company. Each company will have a different way of ensuring the implementation of the CSR strategy within the management structures of the company, but – generally speaking, especially in the case of large companies with multiple operating units – it is often necessary to have a dedicated department that focuses on CSR.

Steinhoff executives may face jail time

Former Steinhoff CEO, Markus Jooste, has been accused of fraud on a grand scale. In one of the biggest corporate scandals, which became public in December 2017, Jooste and his executives have been accused of providing false and misleading information with the intent

to commit fraud against Steinhoff's creditors, employees and shareholders. It is alleged that they were party to submitting untrue written statements to the company's accounts. The impact was widespread, most notably the loss of billions of rands in pension investments of ordinary people. Dubious accounting irregularities resulted in $11,4 billion being wiped out by the company, with a debt of R161 billion being revealed through further investigations.

Christo Wiese, who resigned as chairman a week after Mr Jooste's exit, said that the scandal came as a 'bolt from the blue' and he is looking for answers from Mr Jooste. Mr Wiese lost more than 80 per cent of his personal fortune because of the scandal. He is now suing Steinhoff for lost billions. However, observers are questioning the relationship between the two men, who were college friends and have known each other for decades. Others are questioning the corporate governance system. Steinhoff has a two-tier board - one for management, the other supervisory. In this structure Mr Jooste, as the chief executive, was given a great deal of independence. The supervisory board also relied on the opinions of the company's internationally reputed auditors to review the complexities involved in Jooste's deals. Questions are also being asked about why regulator concerns were overshadowed. In many instances key stakeholders turned a blind eye as the sheer momentum of Steinhoff's share price signalled prosperity and investor confidence.

Magda Wierzycka, CEO of Sygnia Asset Management, and the only female billionaire business owner in South Africa said, during a keynote speech, that she had had enough of cowboys like Markus Jooste and called for business leaders to take a stand against corruption. Wierzycka is among many calling for harsh punishment, not only for Jooste, but also for the executives who have turned a blind eye. David Loxton from Dentons SA said, 'The extent of these allegations show there must have been senior people working together to either hide or turn a blind eye to what was happening...(rather than) expose what they suspected'. Investigations were still ongoing at the time of writing but the Financial Services Board (FSB) said Steinhoff executives might face jail time or a maximum fine of R50 million.

Sources: eNCA. 2017. Steinhoff executives may face jail time: FSB. 13 December. Available at https://www.enca.com/south-africa/steinhoff-executives-may-face-jail-time-fsb [Accessed 10 October 2018]; Head, T. 2018. Magda Wierzycka wants ex-Steinhoff CEO Markus Jooste 'thrown in jail'. *The South African*. 17 August. Available at https://www.thesouthafrican.com/magda-wierzycka-markus-jooste-jail/ [Accessed 10 October 2018]; Haffajee. F. 2018. Why is Markus Jooste in Parliament and not on trial? *Fin24*. 06 September. Available at https://www.fin24.com/Opinion/ferial-haffajee-why-is-markus-jooste-in-parliament-and-not-on-trial-20180905 [Accessed 10 October 2018]; Cotterill. J. 2018. Spotlight on governance as Cape champion turns pariah. *Financial Times*, 22 September. Available at https://www.ft.com/content/d673288a-7bbb-11e8-af48-190d103e32a4 [Accessed 10 October 2018].

In conjunction with the relevant board committee, the CSR department is responsible for identifying the appropriate key performance indicators (KPIs) for implementing the CSR policy and for measuring company performance with respect to these indicators. This information will need to be collected regularly and systematically, and it will need to be reported on to the board committee so that this committee can monitor the implementation of the policy.

The CSR department will also need to ensure that the various business units and line departments, such as human resources, know about the CSR policy and are doing what they can to implement it.

5.4 Sustainable development

Sustainability is the focus of this chapter, as the purpose of CSR is to create sustainability. We have established that the survival and success of organisations are intertwined with, and related to, three interdependent subsystems: the triple context of the economy, society, and the natural environment.[32] To illustrate practically how companies take responsibility for sustainability and engage with stakeholders, we will consider Kumba Iron Ore's approach. This company is 'a leading supplier of high-quality

iron ore to the global steel industry that is focused on creating and sharing value to a range of stakeholders'.[33] This company believes that sustainability and building healthy stakeholder relationships is vital to business success. It aims to build lasting stakeholder relationships and to allow stakeholders to become partners.[34]

5.4.1 Defining sustainable development

'Sustainability' means different things to different people. As a result, there are many definitions of the term. In 1987, the Brundtland Commission supplied the following definition: 'Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.'

This definition encapsulates two key concepts:

- The concept of **needs**, in particular the essential needs of the world's poor, to which overriding priority should be given; and
- The idea of **limitations** imposed by the state of technology and social organisation on the environment's ability to meet present and future needs.

The Brundtland Commission's definition contributed to the understanding that sustainable development encompasses several areas and highlights sustainability as the idea of **environmental, economic and social progress and equity**, all within the limits of the world's natural resources.

The International Institute for Sustainable Development (IISD) explains sustainable development in terms of systems thinking. All definitions of sustainable development require that we see the world as a system – a system that connects both space and time. When the world is considered as a system over space, it is easy to see that air pollution from North America affects air quality in Asia, and that pesticides sprayed in Argentina could harm fish stocks off the coast of Australia. When the world is considered as a system over time, it becomes obvious that the decisions made by previous generations about how to farm the land continue to affect agricultural practice today and that the economic policies endorsed today will have an impact on urban poverty in years to come.[35]

The IISD further states that quality of life can also be a system. Physical health is important, but so is access to education. The value of a secure income is diminished for a person living in an area where the air is polluted. Freedom of religious expression is important, but a person whose family is starving has little interest in this freedom. The concept of sustainable development is thus rooted in this sort of systems thinking. The problems that the world faces are complex and serious and cannot be addressed in terms of the way in which they were created.[36] In the South African setting, addressing inequality in society through economic transformation is a good example of a challenge that affects all three of these sub-systems within which organisations operate.[37]

As a consequence, many intergovernmental conferences have been dedicated to this shared priority. The most influential summits have been the Rio Earth Summit (1992); the World Summit on Sustainable Development (2002); and the Rio+20 United Nations Conference on Sustainable Development (2012). The global development dialogue has also resulted in the development and adoption of principles and goals to solve the interrelated economic, social and environmental challenges of our world. Most notable are the United Nations Global Compact principles (1990), the Earth Charter (1992), the Millennium Development Goals (2000), Sustainability Reporting Guidelines G3 (2006) and the Paris Agreement (2016).

Figure 5.2: Kumba's stakeholder engagement governance framework

Source: Kumba Iron Ore Limited. 2018. *Sustainable Development Report 2017*. Available at https://www.angloamericankumba.com/~/media/Files/A/Anglo-American-Kumba/annual-report-2018/kumba-sustainability-report-2017.pdf [Accessed 20 November 2018], p. 18.

Society doesn't just rely on governments to take responsibility for sustainability; instead they expect organisations and their leaders to take an active role in interacting with, and responding to, the challenges and opportunities presented in the dynamic system of the triple context in which they operate. Such an integrated approach is a hallmark of sustainable development. The key to sustainability is thus to become attuned to the needs, interests and expectations of stakeholders through meaningful engagement and mutual value creation.

Sustainability considerations are entrenched in Kumba's governance structures and sustainability best practice is integrated in their core processes. The company applies a well-defined process to identify and evaluate opportunities and risk, which are material to their business. Figure 5.2 illustrates Kumba's sustainability governance framework. Key to sustainable development is stakeholder engagement.

5.5 Stakeholder engagement

The concept of a stakeholder has already been mentioned in this chapter. You have learnt that one of the ways in which the board and the CSR committee can determine how to establish the corporate policy for CSR is a stakeholder-engagement process.

Other reasons why companies engage with stakeholders include the following:

- Responsible companies want to understand and respond to society's expectations of what it means to be, for example, a responsible manufacturer, marketer and employer.
- Engagement is a means to help build better relationships with all parties, resulting in improved business planning and performance.
- Engagement helps to provide opportunities to align business practices with societal needs and expectations, helping to drive long-term sustainability and shareholder value.

5.5.1 Defining stakeholders

Stakeholders are persons or groups who are potentially affected by, or affect, a company's business activity. Stakeholders could have, or claim, ownership rights or interest in a corporation's activities. These claims may be legal or moral, individual or collective. Stakeholders with similar claims, rights or interest can be classified as belonging to the same group – for example, staff, clients, and traditional leaders.[38]

On a basic level, there are two kinds of stakeholders. **Primary stakeholders** are stakeholders whose ongoing support for the company is vital for its survival. These stakeholders commonly have some contractual or financial relationship with the company. Most importantly, primary stakeholders include shareholders and employees. A company cannot survive if shareholders or employees withdraw their support for the company. In many instances, government is also a primary stakeholder. For example, government would be a primary stakeholder in a mining company because the company would depend on government permission to mine. A local community could also be a primary stakeholder of a mining company, especially if that community owned the land that the company needed. Local community protest or sabotage can make a mine's operation impossible.

Secondary stakeholders are stakeholders who have a less direct impact on the company. Secondary stakeholders could include environmental NGOs or the media, for example. However, there is no clear distinction between primary and secondary stakeholders. A secondary stakeholder can become a primary stakeholder if the conditions change. For example, a local group that is small and powerless probably has little impact on a company, but if it gets more local support or if it has a convincing legal argument, it can quickly become a primary stakeholder.

As a result, stakeholders impose various responsibilities on the company. All stakeholders are important, but the degree to which they are prioritised by the company may change depending on the issue, and factors such as influence, knowledge, credibility and legitimacy.

Kumba considers stakeholders as groups who are important to the company and its operations, as well as those impacted by, or have the potential to impact, the company. The company has regular, proactive and meaningful engagement with key stakeholders to reinforce their collaborative approach. Stakeholders are partitioned into nine broad stakeholder groups, namely government and political groups; shareholders and investors; employees and trade unions; industry bodies; communities; suppliers; business and development partners; media and civil society (e.g. NGOs).[39]

Applying the concept One-way communication, consultation and dialogue

It is worthwhile differentiating specifically between the terms ‘one-way communication’, ‘consultation’ and ‘dialogue’ because they are often used interchangeably but mean completely different things when referring to stakeholder engagement. Communication generally means ‘any manner of information sharing with stakeholders, generally through one-way, non-iterative processes’. It needs to be accurate and timely. Channels of communication include company brochures and reports, newsletters, briefings, press releases, conference presentations, displays and websites.

Consultation is ‘the process of gathering information or advice from stakeholders and taking those views into consideration to amend plans, make decisions or set directions’. The organisation arranges the consultation, sets the terms, and the final decision lies with the company. Consultation enables companies to improve their decision-making and performance by soliciting external perspectives on current issues; community needs and expectations; or impacts of services or performance. Channels for consultation include questionnaire surveys, focus groups, ad hoc advisory meetings and feedback mechanisms such as response forms.

Dialogue involves an ‘exchange of views and opinion to explore different perspectives, needs and alternatives, with a view to fostering mutual understanding, trust and co-operation on a strategy or initiative’. Participants in a dialogue seek to understand and learn from each other’s perspectives and experiences. They do not seek to defend their own perspectives, as in a debate. Open dialogue based on mutual respect leads to learning, trust and co-operation. Dialogue often involves long-term relationships. It requires a high degree of transparency and trust. Both parties must be willing to listen, put aside bias, suspend judgement and take the other party’s views seriously. Dialogue often aims to find agreements for future action. There should be an understanding that trade-offs and compromise may be necessary. Channels for dialogue include multi-stakeholder forums, long-term advisory panels, leadership summits, one-on-one meetings, roundtable sessions and workshops and virtual engagement on intranets and the Internet.

Source: Stakeholder Research Associates Canada Inc. Partridge, K. Jackson, C., Wheeler, D. & Zohar, A. 2005. From words to action. The Stakeholder Engagement Manual. Volume 1: The guide to practitioners’

perspectives on stakeholder engagement. Available at http://stakeholderresearch.com/wp-content/uploads/sra-2005-words-to-action-stakeholder-engagement-01.pdf pp. 6, 14, 21, 22. Reprinted by permission of Stakeholder Research Associates Canada Inc.

5.5.2 Defining engagement

You may define engagement as a promise to marry someone and associate the term with a diamond ring. However, in the context of stakeholder engagement, this term refers to an ongoing and multifaceted process between the corporation and stakeholders that can include:[40]

- providing information;
- capacity-building to equip communities and stakeholders to engage effectively;
- listening and responding to community and stakeholder concerns;
- including communities and stakeholders in relevant decision-making processes;
- developing goodwill and a better understanding of objectives and priorities leading to confidence in decisions; and
- establishing a realistic understanding of potential outcomes.

The parties to engagement may change over time, but engagement itself is a continual process. The different levels of engagement are set out in Table 5.1 on page 187. The level of engagement is determined by the goals aspired to through the interaction with stakeholders, the mode of communication with stakeholders, the nature of the relationship between the company and its stakeholders, and the engagement approach used with the stakeholders.

Kumba's stakeholder engagement strategy is self-regulating and informed by various principles, standards, rules and guidelines. The company applies a combination of engagement initiatives to meaningfully engage with stakeholders. These engagements, as well other CSR initiatives, are reported in compliance with listing and legal requirements. Sustainability reporting provides a transparent account to stakeholders on how Kumba addresses the most material sustainability issues. The annual sustainability report is compliant to the GRI's (formerly Global Reporting Initiative) Sustainability Reporting Standards (core compliance) and their Mining Sector Supplement; the AA1000 stakeholder engagement standard; the sustainable development principles and reporting framework of the International Council on Mining and Metals (ICMM); and the principles of the United Nations Global Compact (UNGC). The company also publishes an annual Integrated Report (IR), Annual Financial Statements (AFS), and an Ore Reserves and Mineral Resources (ORMR) report. The reporting process for all reports is guided by the principles and requirements contained in International Financial Reporting Standards (IFRS), the IIRC's International <IR> Framework, the GRI's Standards, the King Code on Corporate Governance 2016 (King IV), the JSE Listings Requirements and the Companies Act (No. 71 of 2008). Finally, the company uses a combined assurance model to provide assurance from management and from internal and external assurance providers. For example, PricewaterhouseCoopers (PwC) has been appointed to provide an independent assurance over selected sustainability key performance indicators.

5.5.3 Principles for stakeholder engagement

Several important approaches to guide and govern the entire stakeholder-engagement process are described below. Note that different companies will apply these approaches differently with each stakeholder issue.

Kumba's philosophy of stakeholder engagement is informed by its corporate values, which are:[41]

- **Health and safety**: Safety and health are always first on our agenda. We are committed to zero harm. We believe that all fatalities and injuries are preventable and that by working together we can make safety and health a way of life, inside and outside of the workplace.
- **Care and respect**: We always treat people with respect, dignity and common courtesy – regardless of their background, lifestyle or position. We are building trust through open, two-way communication every single day.
- **Integrity**: Integrity demands taking an honest, fair, ethical and transparent approach in everything we do. It is not about being popular; it is about always doing the right thing.
- **Accountability**: We take ownership of our decisions, our actions and our results. We deliver on our promises and acknowledge our mistakes. Above all, we never pass blame.
- **Collaboration**: No one here is on their own. We are one company with a shared ambition – all working together to make appropriate decisions and get things done more effectively.
- **Innovation**: Challenging the way things have always been done is a key priority. By actively developing new solutions, encouraging new ways of thinking and finding new ways of working, we are significantly improving our business.

Key approaches to the stakeholder-engagement process

A company that has grasped the importance of actively developing and sustaining relationships with affected communities and other stakeholders throughout the life of its project will reap the benefits of improved risk management and better outcomes on the ground. On the other hand, a company that is perceived as engaging with stakeholders only when engagement suits its purposes, or when it wants something from those stakeholders, may be undermining its own interests.

Remember these five key words throughout the stakeholder-engagement process:

- **Involvement**: Encourage broad involvement by welcoming interested parties and respecting their roles. Build existing relationships and find new participants to enrich dialogue.
- **Candour**: Be comprehensive. Make sure that you consider every issue. Build trust by creating an environment in which different opinions are welcome. Be candid. Disclose your agenda, assumptions, goals and boundaries.
- **Relevance**: Make the process relevant by focusing on the issues of greatest importance. Share knowledge so that all participants have access to pertinent information. Ensure that the process is timely and that the process takes place when new information can influence decisions and actions.
- **Learning**: Uncover new perspectives. Seek mutual understanding and identify mutually beneficial solutions to problems. Focus on the future. Emphasise what can be done to resolve issues.
- **Action**: Act on results by applying what has been learnt to improve business planning and decision-making. Provide stakeholders with evidence of how the results of the process will be used.

Source: International Finance Corporation. 2007. *Stakeholder Engagement: A good practice handbook for companies doing business in emerging markets*. Available at https://www.ifc.org/wps/wcm/connect/938f1a0048855805beacfe6a6515bb18/IFC_StakeholderEngagement.pdf?-MOD=AJPERES [Accessed 29 November 2018].

5.5.4 The stakeholder-engagement process

The information that follows provides a framework for the stakeholder-engagement process.

Steps in the stakeholder-engagement process

The stakeholder-engagement process can be implemented by following the six basic steps explained below:

- **Prepare**. Identify and understand the territory to be explored through the engagement process with stakeholders. Determine the most important issues in which stakeholder engagement might be helpful and which kinds of stakeholders might be considered for engagement.
- **Plan**. Set objectives and parameters for the engagement process and identify and prioritise stakeholders with whom to engage. Decide how an adequate objective for the engagement process can be set and how the process can be kept within bounds. Consider who should be accountable for engaging and how to determine exactly which stakeholders should be involved. Decide on the best mode of discussion to have and how to measure the success of the process.
- **Design**. Co-develop the engagement plan, including the agenda and logistics, to meet the engagement objectives. Determine how and when to extend an invitation to explore whether engagement is possible and which objectives might be mutually agreed to for the engagement. Consider the best way to conduct the sessions, whether an independent third-party facilitator will be required, and which logistics and rules must be in place. Decide whether it is necessary to verify or audit the engagement.
- **Engage**. Successfully meet the objectives through execution of the engagement plan with stakeholders. Before doing this, establish whether the correct background information, materials and training to begin the engagement are available. Decide on the steps or actions that will follow the engagement.
- **Evaluate**. Assess the outcomes of engagement for both the company and stakeholders against specific objectives. Decide whether further engagement sessions are necessary and use the predetermined criteria to assess whether the engagement was successful. Consider the outcomes and establish whether the process was helpful.
- **Apply**. Share information and integrate the outcomes of the engagement process appropriately into business practices. Decide how to ensure that the results of the engagement reach the right internal decision-makers and how to inform stakeholders about follow-up from the engagement session.

Source: Compiled from information in International Finance Corporation. 2007. *Stakeholder engagement: A good practice handbook for companies doing business in emerging markets*. For more information go to https://www.ifc.org/wps/wcm/connect/938f1a0048855805beacfe-6a6515bb18/IFC_StakeholderEngagement.pdf?MOD=AJPERES.

The outcome of the engagement process needs to be a well-documented plan outlining stakeholder concerns, their impact, as well as the required responses. Table 5.1 is an example of how engagement with the government, regulatory and political stakeholder group was documented within Kumba's annual sustainability report.

Table 5.1: Government, regulatory and political stakeholder group – material interest and strategic response

Source: Kumba Iron Ore Limited. 2018. *Sustainable Development Report 2017*. Available at https://www.angloamericankumba.com/~/media/Files/A/Anglo-American-Kumba/annual-report-2018/kumba-sus-tainability-report-2017.pdf [Accessed 20 November 2018], p. 21.

Kumba and many other corporations internally align their overall stakeholder engagement process to the AA1000 AccountAbility Principles Standard. The AA1000 AccountAbility Principles Standard, AA1000APS (2008),[42] includes three principles: the foundation principle of inclusivity and the principles of materiality and responsiveness. Together, the three principles support the realisation of accountability.

The principle of inclusivity prescribes that an organisation shall be inclusive and allows stakeholders to participate in developing and achieving an accountable and strategic response to sustainability. To allow for inclusivity, the stakeholder participation process needs to make provision for:

- the necessary competencies and resources to enable stakeholder participation;
- the identification and understanding of stakeholders in terms of their capacity to engage, and their views and expectations;
- the planning, development and implementation of appropriate engagement strategies, plans and modes of engagement for stakeholders; and
- established ways for stakeholders to be involved in relevant decisions.

The principle of materiality prescribes that organisations identify their material issues. Material issues are issues that are relevant and significant to an organisation and its stakeholders. These issues would typically influence the decisions, actions and performance of an organisation or its stakeholders. The materiality determination process requires:

- the identification of issues that stem from a wide range of sources, including the needs and concerns of stakeholders, societal norms, financial considerations, peer-based norms and policy-based performance;
- that issues are evaluated against suitable and explicit criteria that are credible, clear and understandable as well as replicable in a manner that is defensible and assurable;
- that findings from the evaluation should be used to determine the significance of each issue; and
- that organisations take into account the changing sustainability context and maturity of issues and concerns, and include a means of addressing conflicts or dilemmas between different expectations regarding materiality.

Finally, the principle of responsiveness prescribes that organisations shall respond to stakeholder issues that affect its performance. This principle requires organisations to have the required competencies as well as a process in place for developing appropriate responses. Responses should be timely and need to be comprehensive and balanced.

These principles oblige an organisation to involve stakeholders in identifying, understanding and responding to sustainability issues and concerns, and to report, explain and be answerable to stakeholders for decisions, actions and performance. Kumba has regular, proactive and meaningful engagements with their key stakeholders. An example is the annual 2017 Stakeholder Day. Such events are used to bring directors and the executive together with provincial and local government, labour unions, business partners, development partners, suppliers, host community groups and civil society, to discuss transformation and sustainability. Constructive feedback received through this event also informed their strategic responses to stakeholder interests.[43]

5.5.5 The contribution of CSR to sustainable development

The private sector has the finances, management expertise and technology to contribute to sustainable development through CSR. A corporation with an interest in ecological issues might extend this interest to a business interest in sustainable development. Another example is the substantial power that business enjoys in many issues of sustainable development. This includes the power to self-regulate and to regulate its supply chains to enhance sustainable development. See, for example, the value created by Kumba for stakeholders in 2017 in Figure 5.3.

Figure 5.3 Kumba's value creation for stakeholders in 2017

Source: Kumba Iron Ore Limited. 2018. *Sustainable Development Report 2017*. Available at https://www.angloamericankumba.com/~/media/Files/A/Anglo-American-Kumba/annual-report-2018/kumba-sustainability-report-2017.pdf [Accessed 20 November 2018], p. 3.

However, there are also limits to the extent to which corporations can be held responsible for sustainable development. Many negative contributions to sustainable development stem from the behaviour of individual members of society. For example, some practices exclude sections of society from the benefits of development, thus threatening social conflict. The failure to adopt sustainable waste-disposal practices and the excessive consumption of public resources such as water are also contrary to sustainable development. Many threats to sustainable development stem from governmental deficits, such as the failure to develop and implement global limits on carbon emissions or the failure to inhibit the destruction of diminishing natural resources such as forests.

Responsible business is therefore a requirement of sustainable development, but it is not sufficient to ensure sustainable development. Corporations, communities, governments and individuals need to work together to achieve this goal.

5.6 Summary

This chapter began by introducing corporate social responsibility (CSR) and the related concepts of corporate social investment and corporate citizenship. It explored CSR by giving a historical overview of its development, followed by a discussion on the social, governmental, market and ethical drivers of CSR programmes and the importance of implementing CSR. The chapter looked at the people responsible for taking leadership of CSR and for formulating policies and frameworks, and the people responsible for legislating policies and frameworks and for implementing programmes. Corporate governance and its relation to CSR were examined. In a discussion on stakeholder engagement, the term as well as its principles and processes were defined and explored. The chapter concluded by defining sustainable development and looking at the contribution of CSR to sustainable development.

Small business perspective

Corporate social responsibility (CSR) is not limited to large corporations. The first word of the term 'corporate social responsibility' seems to suggest that only corporates are affected by this issue. This is, however, a misconception, as CSR increasingly affects all businesses, whatever their size or sector.

Although the requirements of CSR are less formalised for small businesses, CSR involvement is readily and quietly evident in the small business sector. Small businesses

are, for the most part, locally owned and staffed. Their customers are usually concentrated in limited catchment areas, often rural and deprived. These small businesses are both a source of goods for sale and work opportunities. They may not be directly engaged in CSI activity, but they have an unseen CSI impact in their support of the social fabric of their communities, simply through their presence.

CSR is not a simple task. It may be challenging for small businesses to understand exactly what CSR is and how they should identify and formalise their CSR contributions. Because small businesses do not have access to the same resources that corporates have, the extra workload will become the responsibility of the already overworked owner-manager, who may then question the advantage of putting formal CSR policies in place.

Corporate social responsibility thus needs to be all-embracing and the CSR agenda should recognise the diversity of the small business community and its ability to contribute to CSR.

Source: Adapted from Rabin, E. 2003. CSR Applies to Small Businesses Too. *Green Biz*. Available at http://www.greenbiz.com/blog/2003/08/14/csr-applies-small-businesses-too. [Accessed 29 November 2018].

KEY TERMS	
business ethics	King Reports on Corporate Govern
corporate citizenship (CC)	partnership
corporate governance	primary stakeholders
corporate social investment (CSI)	secondary stakeholders
corporate social responsibility (CSR)	stakeholder engagement
environmental, economic and social progress and equity	sustainability report
ethics	sustainable development
executive	triple bottom line (TBL)

Questions for discussion

Reread the case study at the beginning of the chapter and answer the following questions:

1. In your opinion, what are the main drivers of Investec's CSR programme? Explain your answer.
2. Give an example of Investec's contribution to sustainable development.
3. Explain what is meant by the term 'corporate social investment' (CSI)? Use a Investec CSI project to support your explanation.
4. How does a sustainability report differ from a financial report?
5. Explain how Investec's CSR programme finds expression in its corporate governance.

Multiple-choice questions

1.Which of the following statements represents good corporate-governance practices in a company?

a.The executive chairperson is responsible for the running of the board.
b.The chief executive officer is an independent director.
c.The chairperson manages the CSR programme.
d.The chairperson provides leadership for the CSR programme.

2.Which of the following concepts does not relate to discourse on sustainable development?

a.The United Nations Global Compact
b.The UN Conference on Environment and Development
c.The Millennium Development Goals
d.None

3.Which of the following themes were part of a CSR discourse in 2018?

i.Diversity conversations
ii.Workplace harassment and inequality
iii.Corporate activism
iv.Prioritising privacy and data protection

Now select the correct answer

a.i, ii, iii
b.i, iii, iv
c.ii, iii, iv
d.i, ii, iii, v

4.Which of the following aspects are associated with defining stakeholder engagement?

i.Capacity-building to equip communities and stakeholders
ii.Listening and responding to community and stakeholder concerns
iii.Including communities and stakeholders in relevant decision-making processes
iv.Not establishing a realistic understanding of potential outcomes

Now select the correct answer

a.i, ii, iii
b.i, iii, iv
c.ii, iii, iv
d.i, ii, iii, v

5.Which of the following represent the basic steps in the stakeholder-engagement process?

i.Prepare, plan, design, engage
ii.Plan, design, engage, apply
iii.Prepare, Plan, Design, engage, evaluate, apply

iv.Design, engage, evaluate

Now select the correct answer

a.i
b.ii
c.iii
d.iv

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CHAPTER 6

Introduction to general management

Sharon Rudansky-Kloppers

The purpose of this chapter

Entrepreneurs identify opportunities and establish businesses to produce the products and services that the market needs. Entrepreneurs are the driving force behind the venture, but they are not necessarily the only key success factor. Businesses, or the ideas and new ventures of entrepreneurs, need to be managed. That is, the **resources** deployed in the business – such as people, money, equipment and knowledge – must be managed in such a way that the business reaches its profit and other goals. This means that the resources must be planned, organised, led and controlled so that the business maximises its profits. This chapter describes the role of management in the business organisation and examines the four fundamental management functions of the management process, namely planning, organising, leading and control. It also explains the different levels and kinds of management in the business and gives an overview of the development of **management theory.**

Learning outcomes

On completion of this chapter you should be able to:

- give an overview of the role of management in businesses
- describe the four fundamental management functions, namely planning, organising, leading and controlling
- explain the management process
- comment on the different levels and functional areas of management in the business organisation
- describe the various schools of thought in management
- describe the development of management theory.

6.1 Introduction

In Chapter 2, we discussed the entrepreneur, who initiates new ventures and establishes new business organisations. In Chapter 3, we examined the different types of business organisations, such as a partnership, a closed corporation, a private company, and so on. These different organisations, like the many other kinds of organisations such as hospitals, schools and sports clubs that serve society, need to be managed. The purpose of this chapter is to examine the general principles involved in the management of a business.

The case study that follows provides an illustration of how these management tasks are applied in a real-life situation in South Africa.

6.2 The role of management

An organisation may be described as consisting of people and resources, and certain goals that have to be reached. These predetermined goals, which may differ from one organisation to the next, constitute the purpose of an organisation, because humans, as

social beings, arrange themselves in groups to achieve goals that would be too difficult or too complex for an individual to achieve alone. For this reason, a squash club endeavours to get to the top of the league, a hospital tries to make its services as productive and efficient as possible, a political party tries to win an election, and a business endeavours to make a profit and achieve its goals, to mention but a few examples.

However, organisations do not achieve their goals automatically. In addition to the people, **physical resources**, **financial resources** and knowledge in an organisation, a further element is necessary to direct all these resources and activities effectively towards goals. That indispensable element is management. Without this, no purposeful action is possible. All members of the organisation would pursue their own ends in their own ways, and the result would be a waste of time and valuable resources, and the organisation would ultimately fail.

Consider the case study that follows. As much as Woolworths' history appears to be a story of easy success, its success can be attributed to its sound management principles, practices and managers at all levels of the organisation.

One of the most common causes of failure in a business, especially a small one, is poor management. Table 6.1 indicates the main causes of business failure.

It is becoming more and more widely recognised and accepted that the performance and success of an organisation – whether large or small, profit-making or non-profit-making, private or public – depends on the quality of its management.

Table 6.1: Main causes of business failure

Bad management/managerial incompetence	Inadequate pricing
Lack of managerial experience	Poor human resource relations
Lack of industry experience	Failure to understand your market and customers
Lack of clear objectives	Inadequate financing
Poor business planning	No feedback from customers
Poor cash flow management	Absence of performance monitoring
Over expansion	Poor debtor management
Poor marketing	Overborrowing
Poor business location	Lack of financial skills
Economic conditions	Failure to innovate
Failure to adapt to a changing environment	Competition

Sources: Entrepreneur. 2017. Ten reasons why 7 out of 10 Businesses Fail within 10 years. Available at https://www.entrepreneur.com/article/299522. [Accessed 9 December 2018]; Moya.K. 2018. What causes small businesses to fail. http://www.moyak.com/papers/small-business-failure.html. [Accessed 9 December 2018]; Amicable Business Coaching. 9 Reasons why businesses fail. Available at http://www.effectivebusiness.info/failed_business.htm. [Accessed 11 June 2012]; Balovich, D. 2010. What causes businesses to fail? Available at http://www.creditworthy.com/3jm/articles/cw12710.html. [Accessed 11 June 2012]; Ballowe. T. 2015. Ten common causes of business failure. Available at http://onstrategyhq.com/resources/ten-common-causes-of-business-failure/. [Accessed 1 December 2015].

Management is therefore indispensable to any business for the following reasons:

Management directs a business towards its goals. Without the input of managers, the resources of the business would not be channelled towards reaching its goals, and in a market economy few businesses are able to reach their profit objectives without

managers. No business can survive if it cannot make a profit. In short, a business cannot maintain the purpose for its existence without effective management.

CASE STUDY: Management in action

Woolworths was founded in 1931 when the first store opened its doors in Adderley Street, Cape Town. Three years later, a second branch opened in Durban, with another two in Port Elizabeth and Johannesburg a year later. The Woolworths founder, Max Sonnenberg, believed that success lies in providing customers with superior-quality merchandise at reasonable prices. This belief has been instrumental in establishing Woolworths as one of South Africa's leading retail chains.

Woolworths was among the first local retailers to offer employees a pension fund, medical aid and maternity leave. It was also an early adopter of technology. A lease agreement for the first computer was agreed to with National Cash Registers (NCR) in the late 1960s, and Woolworths was already using a computerised merchandising system by the early 1970s. In 1974, Woolworths became the first South African retailer to introduce sell-by dates on food packaging. Woolworths was the first South African retailer to offer pre-washed lettuce and machine-washable wool clothing to consumers. It was also one of the first local retailers to remove as many artificial additives and preservatives as possible from food, and it was instrumental in the successful planting of South Africa's first commercial crop of organically grown cotton. Woolworths was also the first major retailer to make its products available in the 24-hour convenience retail market. By 2009, there were about 40 Woolworths Food Stops in Engen forecourts around the country and by 2018 this number had risen to 74.

Today, Woolworths Holdings Limited is an investment holding company and one of the top 40 companies listed on the Johannesburg Securities Exchange. Its core business focus is the provision of retail (clothing, food, homeware and beauty) and financial services to upper- and middle-income groups, mainly in South Africa but also in Africa, Australia and New Zealand. It employs more than 44 500 employees across 14 countries, and trades in over 1 400 store locations.

Throughout its 80-year history, Woolworths has grown, evolved and adapted to the changing world, and the brand has remained true to its core values. The Woolworths values state: customer obsessed, inspiration, responsible, collaborative and committed to quality. Its vision is 'to be one of the world's most responsible retailers', and the Woolworths mission statement is: 'We provide shared value through retail brands that meet the needs of aspirational customers in the southern hemisphere'.

The WHL group consists of three operating subsidiaries, namely Woolworths Proprietary Limited (Woolworths), Country Road Limited (Country Road Group) and David Jones Limited (David Jones), which was acquired with effect from 1 August 2014. Woolworths Financial Services Proprietary Limited (Woolworths Financial Services) is a joint venture with Absa Group Limited, who has the controlling interest in Woolworths Financial Services.

The Group Chief Executive Officer is Ian Moir, who was appointed in November 2010. He was appointed to the board of Country Road on 23 October 1998 and was formerly Chief Operating Officer of the company before being appointed Chief Executive Officer in November 2000. He was previously Executive Director and Chief Operating Officer of Woolmark.

The group's management believes that its long-term success depends on its ability to implement the WHL Group's strategy and on achieving its targets for each of its strategic focus areas, namely:

- Build stronger, more profitable customer relationships;
- Offer customers a connected retail experience;
- Be a leading fashion retailer in the southern hemisphere;
- Become a big food business with a difference;
- Drive synergies and efficiencies across the group;

- Embed the good business journey throughout its business (in 2007, Woolworths launched its Good Business Journey, which is a plan to make a difference in four key areas, namely transformation, social development, the environment and climate change).

Their five headline goals for 2020 are:

- Contribute R3,5 billion to our communities;
- Save 500 billion litres of water;
- Halve our energy impact by 2020 and source all our energy from renewables by 2030;
- Responsible sourcing of all key commodities; and
- Have at least one sustainability attribute for all directly sourced products.

Sustainability is a key component of the Woolworths strategy and has eight focus areas, namely ethical trade, sustainable farming, energy and climate change, water, waste, social development, transformation and health and wellness.

Woolworths is the main partner of The MySchool MyVillage MyPlanet programme – one of South Africa's biggest community fundraising programmes. In 2017 Woolworths customers raised R105 million for education through MySchool swipes. MySchool MyVillage MyPlanet won three awards at the 2018 Loyalty Magazine Awards for the following categories:

- Best CSR Initiative Linked to Loyalty
- Best Long-Term Loyalty Programme
- Regional Loyalty Champions of the Year for Middle East & Africa.

With regard to ethical trade, the Woolworths Holdings ethical trade positioning statement indicates that they are committed to ensuring that both Woolworths Holdings Limited (WHL) and their suppliers operate in a way that respects workers' rights, maintains safe working conditions, upholds local employment laws and protects the environment and the welfare of animals. Their goal is to ensure that all of their packaging across their food and clothing business is reusable or recyclable by 2022, and that they will eliminate the use of single-use plastic bags by 2020. They are also in the process of removing single-use cutlery and straws from their stores and cafés. All Woolworths suppliers are audited independently against food safety and hygiene standards. With regard to ensuring an ethical supply chain, WHL concentrate on the following:

- *Policies*: We expect our suppliers to share our vision and business codes of conduct. Our code is underpinned by the ILO conventions and the ETI base code.
- *Ethical audits*: We're a member of SEDEX, a transparency tool for ethical auditing. We are working to convert our suppliers to SMETA or other globally recognised audit protocols using the SEDEX data platform, but also continue to audit those who have not yet made the switch against our own independently verified ethical audit protocols.
- *Partnering*: We partner with best-in-class organisations, standards, and certification schemes to tackle complex and systemic issues to further strengthen our relationships with our suppliers.
- *Building capacity*: Training our staff in human rights, ethics and responsible commodity sourcing is key to driving progress.

Woolworths Holdings was included in the FTSE/JSE Responsible Investment Top 30 Index for 2017/2018 and was included in the FTSE4Good Emerging Index Series for 2017/2018. It has been included in the Dow Jones Sustainability Index for the seventh year in succession, as well as on the Emerging Markets Sustainability Index. Woolworths Holdings also maintained its Vigeo Eiris Best Emerging Markets Performers Ranking (the 100 most advanced companies in Emerging Markets universe) as of June 2018 and was listed at #40 in Fortune's Third Annual 'Change the World' List of Companies That Are Doing Well By Doing Good.

Woolworths is one of 27 BRICS' companies selected by The Boston Consulting Group as part of its 2014 BCG Local Dynamos report. 'Local dynamos' are emerging-market firms that have succeeded by staying home and beating both multinationals and local, often state-owned, companies. Woolworths was included for its uniquely ingrained sustainability principles across the business. Woolworths is also investing in the latest technology. It has

recently launched its updated app on Android and iOS with new functions and more security benefits. This resulted in a 166 per cent growth in app registrations for 2017. The app provides customers with daily information on food and fashion and influences their on- and offline buying behaviour.

Sources: Woolworths. n.d. Woolworths Holdings Ethical Trade Positioning Statement. Available at https://www.woolworths.co.za/images/elasticera/New_Site/Corporate/responsible_sourcing_position_statement.pdf. [Accessed 14 September 2018]; Woolworths. n.d. Sustainability. Available at https://www.woolworthsholdings.co.za/sustainability/our-good-business-journey/. [Accessed 15 September 2018]; Woolworths. n.d. Key sustainability indicators. Available at https://www.woolworthsholdings.co.za/wp-content/uploads/2018/09/WHL_2018_Key_Sustain-ability_Indicators_And_Achievements.pdf. [Accessed 17 September 2018]; Woolworths. n.d. Report 2018. Available at https://www.woolworthsholdings.co.za/wp-content/uploads/2018/09/WHL_2018_GBJ_Report_2018.pdf. [Accessed 17 September 2018]; Woolworths. n.d. Purpose, vision and values. Available at https://www.woolworthsholdings.co.za/overview/our-purpose-vision-and-values/. [Accessed 17 September 2018]; Hillock, L. 2017. Woolworths forges ahead with digital strategy. Available at http://www.bizcommunity.com/Article/196/182/170146.html. [Accessed 11 October 2018]; Woolworths Holdings Limited. 2018. 2018 Integrated Annual Report. Available at https://www.woolworthsholdings.co.za/wp-content/uploads/2018/09/WHL-2018-Integrated-Report.pdf. [Accessed 9 December 2018]. Woolworths. n.d. Our history. Available at http://www.woolworths.co.za/store/fragments/corporate/corporate-index.jsp?content=../five-ways/fiveWays&contentId=cmp204261. [Accessed 9 April 2015]; Woolworths Holdings Limited. n.d. Available at http://www.woolworthsholdings.co.za/default.asp. [Accessed 9 April 2015]; Woolworths Holdings Limited. n.d. WHL Directorate. Available at http://www.woolworthsholdings.co.za/corporate/directorate.asp. [Accessed 10 April 2015]; Woolworths Holdings Limited. 2014. *2014 Integrated Report*. Available at http://www.woolworthsholdings.co.za/investor/annual_reports/ar2014/whl_2014_integrated_reprt1.pdf. [Accessed 10 April 2015].

Management sets and keeps the operations of the business on a balanced course. In the microenvironment – that is, within the business itself – a balance must be maintained between the goals of the business, the resources it needs to realise those objectives, the personal goals of the employees and the interests of the owners. Table 6.2 shows four basic kinds of resources found in organisations, namely human resources, financial resources, physical resources such as equipment and raw materials and information or knowledge resources. Management is necessary to combine and direct the resources of different organisations so that each can achieve its goals as efficiently or productively as possible. To Vodacom, the primary goal may be to increase market share and the number of customers. Sasol's primary goal may be a certain profit margin or return on investment, while the management of the University of South Africa will see its goals as improving its teaching through more student support, and better research and service to the community. The management of the City of Tshwane may have as its goal making Pretoria a safer and cleaner city, while the owner–manager of a small bed-and-breakfast establishment may be in business to maintain a standard of living for his or her family. For these goals to be reached, management has to strike a proper balance between resources, interests and goals.

Table 6.2: The basic resources used by an organisation

Typical management tasks

- Who determines where Cell C should next set up cellphone towers in South Africa to ensure widespread cellphone reception for its customers? Management.
- Who decides where the next Nedbank branch will be established? Management.

•In a modest restaurant, who sees that there are adequate funds, equipment, raw materials and staff available to perform the various functions? Management, even if the manager is also the owner of the business.

•Who decides whether Safair will increase the number of its flights to George? Management.

Management keeps the organisation in equilibrium with its environment. On the one hand, management adapts the organisation to environmental change, for example by aligning its employment policy with the requirements of the Employment Equity Act (No. 55 of 1998) or increasing advertising in African languages to communicate with the increased number of black consumers in the market. Recall the case study at the start of this chapter: Woolworths launched its updated app on Android and iOS which provides customers with daily information on food and fashion.

On the other hand, management may try to achieve a better equilibrium with the environment by trying to change the environment itself, in an attempt to reach the organisation's objectives. Developments in the cell phone industry by Vodacom and other cellphone companies regarding the use of mobile applications to send money instead of using cash, has proven successful across many African countries due to both safety and convenience factors.[1]

Management is necessary to reach the goals of the organisation at the highest possible level of productivity. In Chapter 1, we indicated that the economic principle, namely to ensure the greatest possible output with the least possible input, is the reason for the existence of business management.

Thus far, we have shown that management is an indispensable component of the successful functioning of an organisation, especially the business organisation. In the following sections, we shall provide a more comprehensive overview of the task of management.

6.3 A definition of management

Management is defined, quite simply, as the process followed by managers to accomplish a business's goals and objectives. More precisely, management is a process of activities that are carried out to enable a business to accomplish its goals by employing human, financial and physical resources for that purpose. Much has been said about the goals and resources of a business, and the fact that management directs the resources to reach the goals. But how does this process manifest itself? Which form and sequence does the process or activities assume for the accomplishment of business goals?

Although there is general agreement that management is necessary to direct a business toward its goals, the many definitions offered in the literature on management demonstrate the wide differences of opinion among writers and experts about exactly what the activities of management should be. Most experts, however, single out four fundamental activities as the most important tasks of the management process.

Management does four things: it decides **what** has to be done; it decides **how** this should be done; it **orders** that it be done; and, finally, it **checks** that its orders have been carried out. As we have noted, the management terms used to define these fundamental tasks are planning, organising, leading and control. These are the basic tasks of a manager, and they are linked in the sequence shown in Figure 6.1. It would not make sense to perform them in any other sequence, for managers cannot decide to do something unless they know what should be done; they cannot order a task

to be done until they have decided how it should be done; and they cannot check the results before the orders have been given.

Figure 6.1: Basic functions of management

It should be clear at this stage that the fundamental management activities and the resources of a business, as well as its goals, should not be viewed as separate entities, but rather as an integrated process that has to do with the following: planning the goals and the resources to accomplish them, organising the resources and people, leading the people, and, lastly, controlling the resources and the activities of the people.

Figure 6.2 shows management as an integrated process.

Figure 6.2: The four fundamental functions represented as a process

The following brief description of the fundamental management functions elucidates the concept of management and the management process:

- **Planning** determines the mission and goals of the business, including the ways in which the goals are to be reached in the long term, and the resources needed for this task. It includes determining the future position of the business, and guidelines or plans on how that position is to be reached.
- **Organising** is the second step in the management process. After goals and plans have been determined, the human, financial and physical resources of the business have to be allocated by management to the relevant departments or persons, duties must be defined, and procedures fixed, to enable the business to reach its goals. Organising therefore includes developing a framework or organisational structure to indicate how people, equipment and materials should be employed to reach the predetermined goals. Because the goals and resources of different businesses differ greatly, it makes sense that each must have an organisational structure suited to its own peculiar needs.
- **Leading** entails directing the **human resources** of the business and motivating them. Leaders align the actions of employees with the predetermined goals and plans. The part played by leadership in getting and keeping things going in motivating and influencing staff through good communication and relations between management and staff, and among staff, has a decisive effect on the culture prevailing in a business. Managers do not only give orders. As leaders they collaborate with their superiors, equals and employees who report to them, as well as with individuals and groups to reach the goals of the business.
- **Control** means that managers should constantly establish whether the business is on a proper course towards the accomplishment of its goals. At the same time, control forces management to ensure that activities and performance conform to the plans for reaching predetermined goals. Control also enables management to detect any deviations from the plans and to correct them. It also obliges management constantly to reconsider its goals and plans.

Figure 6.2 illustrates the management process as a logical sequence of actions. It is, important, however, to realise that the functions of management do not occur in a tidy,

step-by-step order. Managers do not plan on a Monday, organise on a Tuesday, lead on a Wednesday and control on a Friday. At any given time, a manager is likely to be engaged in several management activities simultaneously.

Critical thinking

How do the management functions of planning, organising, leading and controlling take place in practice? Consider the following information about Sam Dlamini and advise Sam on planning, organising, leading and controlling.

Sam Dlamini completed his BCom degree in Business Management at Unisa and was working for a retail store in the hardware department. He was frustrated because his supervisor told him that his degree would not be of any advantage since there were no management positions open to which he could be promoted. Moreover, he had been in his position for eight years.

So, when Sam's uncle, Jeffrey, asked him to come and help him build up the very successful small printing company he had started three years earlier, Sam was interested. His uncle told him that since Peter (his manager) had died the previous year, it had become very difficult for him to keep the staff together and to process the many orders they received for printing. Despite the demand for their quality products at a very reasonable price, his uncle was unable to keep things running as smoothly as before.

Sam accepted the position of manager and joined the business. Sam found the business in disarray: no one knew which objectives to achieve, who to turn to for advice and authority, which quantities to deliver, or which standards to adhere to. He observed that they were not planning what needed to be done, that resource allocation was haphazard, that no one was taking on leadership, and that there was virtually no control over any activities. He decided that the most important problem was the lack of a proper management process, and that such a process should be implemented immediately.

The management process and the four functions that it comprises are encountered at all levels and in all departments of the business. These will now be examined more closely.

6.4 The different levels and functional areas of management in businesses

Managers are found not only at the top of a business hierarchy, but at all its levels.

Thus, each manager is in charge of a number of managers under him or her. They, in turn, are in charge of a number of employees who report directly to them. A business also has different types of managers, each responsible for the management of a more or less specialised group of activities. Figure 6.3 indicates the integrated management process.

6.4.1 The different levels of management

As shown in Figure 6.3, several **levels of management** may be identified. For the sake of convenience and ease of explanation, however, only three levels – namely, top, middle and lower management – are represented.

Top management comprises the relatively small group of executives who control the business and in whom the final authority and responsibility for the execution of the management process rests – for example, the board of directors, the partners, the managing director and the chief executive – as well as any management committees consisting mainly of members of top management. Top management is normally responsible for the business as a whole and for determining its mission and goals. It is

concerned mainly with long-term planning, with organising insofar as the broad business structure is concerned, and with providing leadership and controlling the business by means of reports and audits. Top management also monitors the environment within which the organisation operates. At the Vodacom Group, for example, top management consists of the board of directors as well as Shameel Joosub (Group CEO), the Chief Financial Officer (CFO), the Chief Operating Officer (COO) and so forth. In a government department, top management typically consists of the minister, the director-general and the deputy directors-general.

Middle management is responsible for certain functional areas of the business and is primarily accountable for executing the policies, plans and strategies determined by top management. Normally, middle management consists of functional heads, such as the marketing manager, the purchasing manager, the human resource manager, and so on. Middle management is therefore responsible for medium- and long-term planning and organising within its own functional areas, as well as for control of its management activities. It should, at all times, also monitor environmental influences that may affect its sphere of operations.

Lower management, also referred to as supervisory management, is responsible for still smaller segments of the business, for example the various subsections that form part of a department. For instance, the marketing department may have a product manager, a promotions manager or a sales manager for certain areas. Supervisors and foremen/women are included in lower management. Their duties mainly involve the day-to-day activities and tasks of a particular section, short-term planning, and implementing the plans of middle management. Lower management supervises the finer details of organising, such as allocating tasks on a daily basis. These managers guide staff in their own subsections and keep close control over their activities. Lower management is often called line management; it is the first management level to which employees from operational ranks are promoted. They then devote most of their time to supervising those employees who report to them.

For the sake of simplicity and convenience, we have distinguished only three levels of management, but in practice the number of levels is determined largely, though not exclusively, by the size of the organisation. The main reason for this is a limit on the number of people whom one person can manage effectively. Peter's Shoe Repairs, a one-person business, for example, has only one level of management, in which the functions of upper, middle and lower management are combined in the person of the owner. A very large business like Edcon, employing thousands of workers, may well comprise many more than three levels.

In Chapter 8, we discuss this question further in our examination of organisational structures.

Figure 6.3: Different levels or types of management in a business or organisation

6.4.2 The functional management areas in a business organisation

Figure 6.3 shows the different levels of management and the different types, or functional areas, of management that may be distinguished, irrespective of level. Functional management refers to specialised managers who are necessary for the

different functions of the business. Functional managers are responsible for only the specified management activities of their functions or departments.

Marketing management, for example, is responsible for the following:

- **Planning the activities of the marketing department.** This means that marketing objectives, for example a 10 per cent increase in market share by 2022, are carried out in accordance with the goals and objectives of the business as a whole, and plans are devised to reach those goals.
- **Organising marketing activities.** An example is the allocation of tasks to persons so that certain objectives can be attained.
- **Assumption of leadership of marketing activities.** This entails motivating and giving orders to marketing staff in order to accomplish the goals and objectives and, if necessary, providing guidelines.
- **Controlling marketing activities.** An example is measuring the results and costs of a campaign against its objectives.

In the same way, **financial management**, **human resource management**, **logistics management**, and other functional managements plan, organise, lead and control their departments. Many organisational functions may be identified, depending on the required number of specialist areas that a business may need. In practice, the number and importance of these specialised areas vary from business to business. There is, however, only one organisational function – general management – that is universally encountered, and that has a definite part to play in every organisation. Some examples of management levels are given in the box below.

Management levels: Some examples

- Sasol has 10 management levels.
- The University of South Africa has approximately eight management levels and some 5 230 employees.
- Small business ventures such as bedand-breakfast establishments typically have one level of management.

6.4.3 The function of general management

One function not shown vertically in Figure 6.3, but that is nevertheless identified as a separate function in the literature and occurs in every business, is **general management**. General management differs from other specialised functions in that it integrates all the others. It deals particularly with the activities of top management, while at the same time manifesting itself in other functions, as in the case of marketing management. General management is therefore the overriding function that controls the management process and the general principles of management as applied by top management.

The same elements of the management process and the general principles of management also affect the other functions, however. This means that all managers in the business should have a thorough knowledge of the management process and its general principles in order to be able to manage their own specialised functions more efficiently. For this reason, general management is discussed as an introduction to the other functions in this chapter, and again in Chapters 7, 8, 9 and 10.

This question may justifiably be asked: ‘Is there any difference between business management (discussed in Chapter 3) as a subject of study and the management process?’ The answer is, decidedly, yes. Business management is the science that examines all the things that affect the productive and profitable operations of a

business. It considers not only the management process, but also the external environmental factors that can influence it, as well as the specialised management areas and various disciplines and techniques. In contrast, the study of the actual management process of a business is only one component of business management. It examines only the management process and the general management principles that enable the business to accomplish its goals and objectives as effectively as possible.

We have described the management process, the levels of management, the functions in which the management process takes place, and the unique position and nature of general management. The skills required of managers in executing the management process, and the roles they play in the business, will now be considered in greater detail.

6.5 Skills needed at different managerial levels

Although management is found at all levels and in all functions of a business, the personal skills needed to do the job differ at each level. Figure 6.4 depicts the different skills.

The skills and abilities necessary for top management to carry out the functions of general management are different from those required by lower management. Three key skills are identified as prerequisites for sound management:[2]

1. **Conceptual skills**, that is, the mental capacity to view the business and its parts in a holistic manner. Conceptual skills involve the manager's thinking and planning abilities.
2. **Interpersonal skills** are also called human relations skills and refer to the ability to work with people. These skills help managers to understand and communicate with people and to lead, motivate and develop team spirit.

Figure 6.4: The skills needed at various managerial levels

3. **Technical skills**, that is, the ability to use the knowledge or techniques of a particular discipline. Knowledge of accountancy or engineering or economics is an example of a technical skill that is required to perform a specified task. Managers at lower levels, in particular, should have sufficient knowledge of the technical activities they have to supervise. However, the time spent on technical activities decreases as managers move up the managerial ladder, where conceptual and analytical skills assume more importance.

Where do managers acquire these skills? One source is management education at schools, universities of technology and universities. Some businesses also provide their own management training. Worldwide there is currently a strong tendency to consider formal academic education in management as a prerequisite for success in business.

Another source of managerial competence is practical experience. A natural aptitude for management, as well as self-motivation and ambition, plays a considerable part in the development of managerial skills.

Critical thinking

What type of skills do South African managers have? How do their educational backgrounds and experience relate to the three key skills required for sound management?

•The CEO of Vodacom Group (Pty) Ltd, Shameel Joosub, holds a Bachelor of Accounting Science (Honours) from the University of South Africa and a Master of Business Administration degree from the University of Southern Queensland.

•Entrepreneur Patrice Motsepe, law graduate and attorney, established the mining company ARMgold in 1997. He currently serves as executive chairman to ARM and also sits on the board of Sanlam.

•Lesetja Kganyago, Governor of the South African Reserve Bank since November 2014, has a Bachelor of Commerce degree and Masters degree in Economics. He has also served as Director-General for the National Treasury and was the Deputy Governor of the SA Reserve Bank.

•Thando Mkatshana , CEO of ARMplatinum since 2017, has a National Higher Diploma (Coal mining) from the Technikon Witwatersrand, a BSc Engineering (Mining) from Wits University, Management Development Program and Master of Business Administration (MBA), both from the University of Stellenbosch.

•Maria Ramos, ex-CEO of Absa Group Limited, holds a banking diploma, a BCom Honours degree, and an MSc degree in Economics.

•Trevor Manuel is a former South African Minister in the Presidency for National Planning Commission. He has been the Chairman of the Board of Governors of the International Monetary Fund since 2002, has completed a National Diploma in Civil and Structural Engineering and an executive management programme and holds no less than seven honorary doctoral degrees in commerce, technology, economics and law.

•Nancy Naidoo, the Human Resource Manager at a medium-sized advertising firm, holds a BCom Honours degree in Human Resource Management.

•Kgomotso Sedibe is a schoolteacher who started her own venture in 2003, a bed-and-breakfast establishment with three rooms. She has completed two management certificate courses and enrolled for a BCom in Hotel and Tourism Management last year.

6.6 The role of managers

Every manager must fulfil a specified role, irrespective of the managerial level or area he or she occupies. A manager, after all, performs certain functions, meets certain needs and assumes certain responsibilities for the business.

As Figure 6.5 shows, the roles of managers can be placed in three overlapping groups, namely interpersonal, information and decision-making roles: Three groups of activities constitute the **interpersonal role** of managers:

•Acting as the **representative figure** who attends charity dinners, meets visitors, attends a colleague's wedding, or opens a new factory.

•**Leading** in the appointment, training, performance, promotion, and motivation of employees.

•**Maintaining good relations** within the organisation and with its public (this role can occupy up to 50 per cent of a manager's time): internal relations involve other managers and individuals; external relations involve suppliers, banks customers, and so on.

The **information role** enables managers to obtain information from colleagues, employees who report to them, superiors and people outside the business, to help them make decisions. This role focuses on monitoring or gathering information about change, opportunities or threats that may affect their department. Managers analyse this information and pass relevant data on to colleagues, superiors and employees who report to them. In this way, they constitute an important link in the business's communication process. The information role also demands that managers act as

spokespeople in their departments or businesses, both internally as well as with the outside world.

The **decision-making role** involves the gathering and analysis of information. In this respect, managers may be regarded as entrepreneurs who use the information at their disposal to achieve positive change in the form of a new product or idea, or the restructuring of their business. Woolworth's management, for example, decided to acquire David Jones based on research reports. Managers also have to deal with and solve problems such as strikes, shortages and equipment breakdowns. Managers have to decide how to allocate the resources of the business. These include funds, human resources and equipment, and the allocation of these is often a critical management decision. In their role as negotiators, managers regularly interact with individuals, other departments or businesses to negotiate goals, performance standards, resources and trade union agreements.

Figure 6.5: The overlapping roles of managers

By viewing managers from a perspective of the different roles they play in a business organisation we gain insight into the manager's task. This is important for the following reasons:[3]

- The concept of a **manager's role** creates an awareness of what a manager does, and hence which skills are required.
- A manager's seniority in the business largely determines his or her role, and how much time is spent on each activity.
- The concept of role distribution explains why managers cannot systematically move from planning to organising to leading and, eventually, to control. The complexity and turbulence of their environment requires a more flexible approach.

The above discussion regarding the management skills required for different management activities, and the role of managers, aims to explain how management works, and should not be viewed as an exact exposition of a management process, because the variables differ from one business to the next. In addition, the four management functions are supplemented by various other activities that also have to be performed by management, again depending on the nature of the business. Besides a knowledge of, and skills in the four fundamental management elements, management also requires a basic knowledge of supporting management activities.

Although many activities may be identified, four main supplementary or supporting management activities are normally distinguished, namely:

- gathering and processing of information to make decisions possible;
- decision-making;
- communication; and
- negotiation.

These supplementary activities are not grouped under any of the four management functions because they occur in each element – for example, information is necessary not only for planning but also for organising, and even more so for control. Similarly, management communicates while planning and organising. Communication is an essential component of leadership. In Chapter 9, these activities are examined in greater depth.

The nature of management may further be explained by examining the evolution of management thought over the past few decades. This will also help to explain the present status of management and the approach followed in this book.

Table 6.3: The development of management theory

State of management until early 1900s	State of management during 20th century	The 21st century: What w management be?
A few large organisations, but no mega-organisations	Many huge and powerful organisations in both the private and public sectors	Emphasis on corporate gove corporate social responsibilit
Comparatively few managers – no middle management	Many managers – a comparatively large middle management group	Influence of rise of emerging China on development of ma
Managerial activities not clearly distinguished from activities of owners	Well-defined managerial activities clearly separated from non-managerial activities	
Succession to top management based primarily on birth	Promotion to top management on a basis of qualifications, competence and performance	
Few decision-makers	Many decision-makers	
Emphasis on command and intuition	Emphasis on leadership, teamwork and rationality	

6.7 The development of management theory

Because management experience and knowledge of the past are important both to present and future management success, it is necessary to provide a brief overview of the development of management theory over the 20th century. In Chapter 1, we briefly outlined the development of business management as a science. The emphasis there was mainly on business management in past centuries, when the entrepreneur both owned and managed his or her business. In contrast to this, the 20th century saw the emergence of the professional manager paid by the owners to manage the business. The manager's level of remuneration often depends on his or her success in managing the business profitably. Table 6.3 gives an exposition of the state of management in previous centuries as opposed to management in the 20th century. It also raises some questions as to the future state of management in the 21st century.

The concept of the professional manager resulted in, among other things, a number of theories or approaches to management. Management scholars as well as practitioners researched management issues, postulated theories about how best to manage a business organisation and published their theories or approaches to management.

Although professional management as we know it today is a product of the 20th century, during its early years there was much uncertainty about what the activities and elements of management actually were. It was only in 1911, with the publication of F.W. Taylor's *Principles of scientific management*, that management was at last placed on a scientific footing.[4] Since then, theories and approaches to management have developed unevenly, with a good deal of overlapping at times. This fitful progress is no doubt attributable to the uneven development of such supplementary disciplines as psychology, sociology and mathematics. With each wave of development in these

subjects, new developments and theories in management evolved, which were in turn followed by more knowledge about the factors that determine the success of a business. At the same time, changes in the business environment resulted in the development of new perspectives on existing management theories.

Most of the approaches to management in the literature of even the recent past reveal a great deal of diversity and overlapping of the views of writers and scholars about what can properly be regarded as managerial activities. The inadequacy of academic research during the formative years of management has, in recent decades, been amply compensated for by an abundance of research and literature. Scholars are all too ready to put forward a wide range of opinions about management. Behaviourists, for example, inspired by the human relations approach of the 1930s, see management as a complex system of interpersonal relations, and psychology as the basis of management theory. Others, again, see sociology as the basis. Some maintain that the essence of management is decision-making, with mathematics playing a central role, while others argue that accounting should be the basis of all management principles and theories. The different viewpoints and approaches towards a theory of management are a reflection of the political, economic, social, technological and environmental issues of the time.

It is often asked whether the various theories and viewpoints of the past have any relevance for the contemporary organisation. Among the many theories about how to improve the performance of the organisation, some aspects of each have survived and, indeed, contributed to contemporary theories on management. In this way, the legacy of past successes and failures becomes part of present and future management approaches. A brief examination of the different theories of management is therefore necessary.

6.7.1 The main schools of thought on management

The existing body of knowledge on management theory or management approaches has emerged from a combination of ongoing research on management issues and the practical experience of certain scholars of management. The management theories that have evolved over many decades are grouped into a number of schools of thought. Each school believed at some stage that it had found the key to management success in terms of productivity and profitability. Later assessments of the various approaches to management, however, demonstrated that these so-called answers to the problems of management were at best only partially correct. Yet, each has made some contribution to the theoretical body of knowledge on management. The theories of management can be classified into two main schools of thought, namely:

1. The **classical** approaches (±1910–1950)
2. The **contemporary** approaches (±1960 to the present).

Figure 6.6 illustrates the development path of management theory.

The classical approaches are discussed below.

Figure 6.6: The evolution of management theory

6.7.1.1 The scientific school

The contribution of the **scientific school** is especially associated with the work of F.W. Taylor (1856–1915). He was an engineer at a steelwork in Philadelphia and believed that a scientific approach to any task would greatly increase the productivity with which it was carried out. Through the scientific application of observation, job analysis, job measurement, the redesign of jobs, and financial incentives (by paying workers according to their output), he and his colleagues proved that the productivity of a business could indeed be increased.

Although research was confined to workers and lower management levels, this school made a valuable conceptual contribution in that managers and academics became convinced that scientific approaches and methods could be applied in productive ways to attain the goals of an organisation.

6.7.1.2 The management process school

The **management process school**, by contrast, concentrated on top management. Its method was to identify the most important functions in a business and the most important elements of management, so that universal principles of management could be developed for each function and element. The theory was that the application of universal management principles would take any business towards its goals.

Henri Fayol (1841–1925) was the originator of this approach. His personal contribution included the identification of six functions of a business:

1. The technical (production-operational management) function
2. The commercial function (purchasing and marketing)
3. The financial function
4. An accountancy function
5. A security function (protection of property)
6. The function of general management.

This functional approach, albeit in a modified form, still receives wide support and offers the following advantages:

- It systematises the great variety of activities and problems in a business.
- It facilitates the internal organisation of a business by classifying activities into departments according to their functions.
- It facilitates management by making it possible to appoint people with the right qualifications to the various functional departments.
- It makes the study of management science considerably easier by grouping similar problems. (This book, for example, is classified functionally.)

Fayol also identified the following fundamental elements of the management process: planning, organising, leading, co-ordinating and control. This description of the management process is still accepted today.

6.7.1.3 The human relations or behavioural school

The **human relations** or **behavioural school** came into being because of the failure of the scientific and classical management process schools to make an adequate study of the human element as an important factor in the effective accomplishment of the goals and objectives of a business. Elton Mayo (1880–1949) found that increased productivity was not always attributable, as the scientific school believed, to a well-designed task and sufficiently high wages. It could also be attributed to such factors as the relationship between people in the business – between management and workers, and between workers themselves in a particular group.

The basic premise of this school is that psychological and sociological factors are no less important than physical factors in the attainment of the goals of a business.

Research into social interaction, motivation, power relations, organisational design and communications forms the basis for the contributions by this school, which are particularly valuable in the area of personnel management.

6.7.1.4 The quantitative school

The **quantitative school** sees management primarily as a system of mathematical models and processes. It is largely composed of operational researchers or decision experts who believe that if management or any elements of it are at all a logical process, then this should be expressible as mathematical relations.

The contribution of this school, particularly in the development of models for the running of complex processes, is important. However, this school should be regarded as an aid to management rather than as a separate school of management theory.

6.7.1.5 The systems approach

The **systems approach** to management developed in the 1950s. This approach compensated for the main limitations of the previous approaches. These limitations were, firstly, that they ignored the relationship between the organisation and its external environment, and secondly, that they focused on only one aspect of the organisation at the expense of other areas. Some managers would, for example, focus only on financial aspects and neglect the organisation's market and customers. To overcome these shortcomings, management scholars developed the systems theory, which views the organisation as a group of interrelated parts with a single purpose, where the actions of one part influence the other parts.

Managers cannot, therefore, manage the separate parts independently, but should rather manage them as an integrated whole. This approach was the forerunner of the concept of **strategic management**.

6.7.2 Some contemporary approaches to management

During the second half of the 20th century, the environment in which business organisations operated began to change at an increasing rate, as explained in Chapter 4. Because of the rapidly changing environment, new issues and challenges emerged and so, too, did new approaches to management. The contemporary schools of thought were ushered in by the concept of strategic management, followed by a number of contemporary approaches, which we outline below.

6.7.2.1 The contingency approach

The **contingency approach** seeks to eliminate the defects of other theories. Like the systems approach, it attempts to integrate the ideas of the different schools. The basic premise of the contingency approach is that the application of management principles depends essentially on a particular situation confronting management at a particular moment. In a given situation, management will decide to apply the principles of the functional, quantitative or behaviourist school, or combinations of these. In other words, the contingency approach attempts to adapt the available techniques and principles provided by the various management approaches to a given situation, so as to reach the objectives of the business as productively as possible. It may be said that this approach does not really recognise the existence of universal principles of management, but instead concentrates on whatever means are available to solve problems.

6.7.2.2 Strategic management

Strategic management as an approach to organisational success evolved from the turbulent environments of the 1960s and 1970s. The pace of technological change, the emergence of Japan and other new post-World War II economies, and demographic

change, as well as other political and social trends, forced management to align the goals and objectives of their organisations with trends in the business environment. By focusing on the threats and opportunities in the environment, and evaluating its strengths and weaknesses in order to overcome the threats and exploit the opportunities, the organisation builds a distinct competence in a particular market.

During the early years of the strategic management approach, large organisations had to make big strategic planning decisions. Since the 1980s, however, many of these decisions have been abandoned because today every manager in the organisation is required to think and act strategically. Today, businesses involve managers from all levels of the organisation in the strategic planning process.

6.7.2.3 Total quality management

Total quality management (TQM) is one of the contemporary management approaches that evolved during the late 1980s and the 1990s and revolves around the matter of quality. American managers examined the success of their German and Japanese counterparts in the American market, and found that the latter were obsessed with quality. What further inspired management scholars was the fact that Japanese and German managers not only delivered top-quality products and services, but did so at a higher rate of productivity.

6.7.2.4 The learning organisation and the reengineering of businesses

The management theories that evolved in the 1990s relate to the concepts of **the learning organisation** and the **re-engineering of businesses**.

- The learning organisation is a management approach that requires learning individuals. The inability to learn can cripple an organisation.
- Re-engineering is a management approach that forces the organisation to focus on its core business and to outsource those activities that do not relate to the core business. Since the 1990s, most organisations have reduced the size of their workforces by outsourcing activities such as the company cafeteria, garden services, maintenance, and a host of activities that are unrelated to the organisation’s core business. Telkom reduced its workforce from 67 000 employees in the early 1990s to approximately 28 000 by 2007. In January 2015, Telkom employed approximately 18 384 employees. In 2017 this number was 18 847. Telkom’s workforce is, however, about 30 per cent bigger than those of its peers. Its planned 4 000-plus job cuts met with strong union opposition and three unions challenged Telkom’s plans in court, saying they were not consulted adequately.[5]

6.7.2.5 Diversity management

Diversity management is another important challenge in contemporary management. In South Africa, the management of diversity is partly enforced by the Employment Equity Act (No. 55 of 1998). Management in Africa will, in due course, develop a management approach with a body of knowledge that is peculiar to the needs and cultural diversity of the continent.

Contemporary business issues that could shape management theory in the 21st century include **corporate governance**, **corporate social responsibility** (also referred to as **corporate citizenship**) and **knowledge management**. Corporate social responsibility was discussed in Chapter 5. Management approaches and theories are important instruments for broadening knowledge about management. The student of management will, accordingly, be equipped to take a critical view of new ideas and new approaches to management.

Ubuntu: an African perspective

The upbringing and socialisation of individuals in African society have always emphasised interpersonal, informational and decision-making roles. Interpersonal roles are subsumed in the notion of *ubuntu* in Zulu and Xhosa, *unhu* in Shona, *botho* in Tswana, *broederbond* in Afrikaans, *bunhu* in Tsonga, *vhuthu* in Venda, and brotherhood in English. Thus, *ubuntu* is a literal translation of the notion of collective personhood and collective morality. *Ubuntu* is defined as 'humanity to others' and 'I am what I am because of who you are'. It is at the core of doing business in Africa. It can establish progressive business partnerships and organisational activities and strategies that encourage the economic growth of African communities.

Therefore, a leader (*mutugamir* in Shona, and *umukhokheli* in Zulu) guided by the *ubuntu* philosophy is expected to inform and communicate with his or her own group and to be its mouthpiece in external communication. Decision-making is the hallmark of leadership, which involves analysis of the situation at hand, in consultation with others, and guiding the process until a course of action is selected.

Sources: Choeu, C. 2016. *Ubuntu Is at the core of doing business in Africa*. Available at https://www.communication-director.com/issues/ubuntu-core-doing-business-africa#.W78Pc2gzY2w. [Accessed 11 October 2018]; Mbigi, L. 1997. *Ubuntu: The African dream in management*. Randburg: Knowledge Resources; Moyo, R. 2015. *Ubuntu, Applying the African Cultural Concept to Business*. Available at https://www.africanexponent.com/post/ubuntu-applying-the-african-cultural-concept-to-business-75. [Accessed 11 October 2018].

The Impact of the Fourth Industrial Revolution on business

The work environment is changing. Technological advancements have had a major influence on these changes. Some of these changes are listed below:

1. Communication has improved because of technological inventions such as smart phones, tablets and social networking. Communication among management members, from management to employees or among employees has become faster, immediate, collaborative and unified.
2. Enabling of remote working. Employees can now work anywhere with a WiFi signal and can be available at a moment's notice.
3. Cloud computing has enabled businesses to move some of their operations to third-party servers which are accessible via the Internet. This has the advantages of variable data packages as well as fast expansion and mobility without fearing downtime, crashes or lost data.
4. Technology is keeping businesses organised. Businesses use systems such as Project Management Software to assist in the planning, delegating, reviewing and assessing of tasks. It is easier to supervise activities, and everything can be kept on track. It helps to improve the responsibility, accountability, efficiency and timely delivery of tasks assigned to employees.
5. Advanced technology aids in better customer segmentation. By using analytical services and systems, the market can be segmented into more specific groups and targeted directly. Google accounts can inform a business about the location of visitors to the site, the type of browser used, how they found the website, how long they stay, and at which point they leave.
6. Technology is improving the productivity and performance of businesses. They make use of business productivity software which helps managers to track progress during each phase of a project and offer instant reinforcement or coaching to keep performance and deadlines on track.
7. Costs can decrease because of the implementation of innovative technological software which helps to manage costs at different levels and improve profitability.
8. Businesses make use of security software which enables accessibility of sensitive information to the right employees and prevents malicious hacking attempts. It also helps to reduce the threat of data thefts and leaks.

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6.7.3 Conclusion

The above examination of how management theory has evolved and contributed to the broader body of knowledge on management clearly shows that there is no single uniform and consistent theory of management that may be universally accepted and applied. However, understanding the historical context provides us with a broad perspective on the vastness of the body of knowledge, particularly with regard to the research, principles, problems and approaches to management, on which managers can draw.

We have adopted the process paradigm in this chapter because it offers a conceptual framework for the study of management, it simplifies the subject, and it favours the development of a universal theory of management.

6.8 Summary

This is the first of five chapters dealing with general principles of management. We have learnt that management is an indispensable component of any organisation, without which the organisation's resources cannot be properly utilised to reach its goals and objectives. In addition, we have defined management as a process that consists of four fundamental elements or management functions: planning, organising, leading and controlling.

Management – that is, the functions of planning, organising, leading and controlling – also represents a distinct function, namely general management, which, at the top level, predominates, and also co-ordinates other management areas. At middle- and lower-management levels, the management process is evident in every business function. Each level of management requires certain skills, and the roles played by managers differ from one level to the next.

Our examination of the evolution of management theory and the various approaches to it has shown how the different schools of thought have contributed to the vast body of management knowledge. The process approach, which distinguishes four tasks of management and seven functions within a business, forms the basis of this book. In the next four chapters, the various elements of the management process will be examined more closely.

Small business perspective

As in the case of large organisations, the four management principles also impact on the success of the small business enterprise. In many small businesses, however, the formal planning process does not take place, and a lot of the planning is done informally. The advantage of compiling a formal business plan for a small business owner is that it allows him or her to evaluate quickly how unexpected opportunities could be of benefit to the business. Small business owners will also require a business plan in order to apply for finance from banks or other financial institutions. Where organising in the small business is concerned, the owner is usually involved in all the business tasks and areas and all the employees usually report to the owner, thus making it a very simple organisational structure. Good leadership in a small business is essential and, just as in large organisations, employees also need someone to look up to and who can motivate and inspire them to do their best. A problem in small businesses, however, is that small business owners or

managers do not easily delegate authority, which can impact negatively on the growth of the business. Control in the small business is usually handled by the small business owner or manager personally. It is required to ensure that the business is profitable and that it survives and prospers. The small business owner should, for instance, have a budget in place that will warn him or her when the business is approaching its financial limits.

KEY TERMS	
conceptual skills	lower management
contemporary approach	management
contingency approach	management principles
controlling	management process
corporate governance and citizenship	management theory
decision-making role	marketing management
diversity management	middle management
financial management	organising
financial resources	physical resources
Fourth Industrial Revolution	planning
functional management	quantitative school
human relations or behavioural school	re-engineering of a business
human resource management	resources
human resources	school
information resources	scientific school
information role	strategic management approach
interpersonal role	systems approach to management
interpersonal skills	technical skills
leading	top management
learning organisation	Total quality management approach
levels of management	types of management

Questions for discussion

Reread the 'Management in action' case study at the beginning of the chapter and answer the following questions:

1.What are the core values of Woolworths?

2.Woolworths' management should direct the business towards its goals. What are the key strategic goals of the organisation?

3.Which skills should Ian Moir have as CEO of Woolworths?

4.Which roles do the managers at Woolworths play? How do these roles differ from management level to management level?

5.How does Woolworths ensure ethical business practice?

Multiple-choice questions

1.Identify the **most dominant** cause of business failure.

a.Managerial incompetence
b.Lack of leadership
c.Excessive competition
d.Lack of managerial experience

2.The theory or approach to management that attempts to adapt the available techniques and principles provided by the various management approaches to a given situation to reach the objectives of the business as productively as possible is known as:

a.theory Z.
b.the systems approach.
c.the contingency approach.
d.the excellence movement.

3.Which one of the following activities constitute the **interpersonal role** of managers?

a.The gathering and analysis of information.
b.Leading in the appointment, training, performance, promotion, and motivation of employees.
c.Allocating the resources of an organisation.
d.Analysing information and passing data onto colleagues.

4.____________is a process of activities that are carried out to enable a business to accomplish its goals by employing human, financial and physical resources for that purpose.

a.Corporate governance
b.Social responsibility
c.Management
d.Diversity management

5.What do you associate cloud computing with?

a.The learning organisation B. Fourth Industrial Revolution

c.Re-engineering a business

d.Total quality management.

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CHAPTER 7

Planning

Mari Vrba

The purpose of this chapter

The purpose of this chapter is to explore the concept of planning as the first of four management functions, as defined by the management process introduced in Chapter 6. Planning is the basis for the rest of the management functions, and incorporates goals and plans. Plans specify how the organisation will achieve its goals. The management process takes place in the context of the environment in which the organisation operates.

Learning outcomes

On completion of this chapter, you should be able to:

- explain the nature of planning as a management function
- describe the importance of planning as the first step in the management process
- describe the planning process
- interpret goals meaningfully
- describe the different organisational goals
- depict the hierarchy of goals
- differentiate between strategic, functional and operational planning
- differentiate between different strategies to accomplish different goals.

7.1 Introduction

Planning gives direction to the organisation. It forces managers to be future-oriented and enables the organisation to deal with changes in the business environment. In this chapter, we briefly explain the benefits and costs of planning in organisations. Then, we focus on the two components of planning, namely goals and plans, and explain the planning process. We also discuss the focus of planning at the various levels of an organisation.

The following case study illustrates how a successful integrated financial services organisation uses the planning function to ensure that it remains competitive in a dynamic and ever-changing global environment.

CASE STUDY: Discovery Limited

Discovery was established in 1992 as a small specialised risk insurer with the support of Rand Merchant Bank. According to founder and Group CEO Adrian Gore, the founders did not have a clearly defined business plan or specific growth targets when they started the company. Instead they were inspired by the positive impact a large institution could have on society by finding innovative solutions to societal needs.

The core purpose of the company, set at its inception as a specialist health insurer, was to make people healthier and to enhance and protect their lives. The business has grown into a global, integrated financial services organisation operating in 19 countries and impacting 17,8 million lives globally (in 2018), and retains the same focus.

The evolution of Discovery

•1992: Discovery Health launches its ground-breaking, innovative medical savings account, placing clients in control of their day-to-day medical spending.

•1997: Launches Discovery Vitality, the internationally recognised, scientifically proven wellness programme that draws on behavioural economics.

•1999: Discovery Limited lists on the Johannesburg Securities Exchange.

•2000: Enters the life insurance industry by launching Discovery Life.

•2004: Launches Discovery Card, a Visa-based credit card that rewards members for being healthier.

•2004: Enters the United Kingdom market by forming a joint venture, PruHealth, with Prudential plc.

•2007: Discovery Limited and Prudential plc. launch PruProtect in the UK, offering Discovery products in the UK.

•2007: Launches Discovery Invest, entering the savings and investment industry.

•2009: Expands into China by acquiring a 25 per cent share in Ping An Health Insurance Company of China Ltd, a wholly-owned subsidiary of Ping An Insurance (Group) Company of China.

•2010: Expands in the UK by acquiring Standard Life Healthcare and merges its insurance book with that of PruHealth, thus creating the fourth largest private medical insurance company in the UK.

•2011: Launches Discovery Insure, thus entering the short-term insurance industry.

•2012: Expands product offering in China by launching Vitality to Ping An Health insurance clients in China.

•2013: Vitality is globally recognised as the global gold standard at the 2013 World Economic Forum Annual Meeting in Davos, Switzerland.

•2013: Expands further into Asia by launching a joint venture with AIA Group Limited in Singapore, the largest publicly listed Pan-Asian life insurance group. AIA Vitality makes Discovery's successful wellness-based life insurance model available to the Asia-Pacific region.

•2014: Takes full ownership of PruHealth and PruProduct in the UK and rebrands to Vitality Health and Vitality Life.

•2014: Expands to Europe by forming a strategic partnership with the General Group to bring the wellness solution to Europe.

•2017: The Vitality Group in the US and Discovery Partner Markets (that managed partnerships with leading insurers) are restructured to become Vitality Group. The Group forms partnerships and joint ventures to implement Vitality Shared-Value Insurance in many parts of the world.

•2017: A report released at the World Economic Forum in Davos names Vitality Group a leading health innovator.

•2017: The Registrar of Banks grants Discovery a banking licence, subject to specific regulatory conditions, including conditions relating to the proposed shareholding in the bank, and Competition Commission approval.

•2017: Launching of Global Vitality Network (GVN), which uses the Vitality One technology infrastructure to offer a globally unified systems architecture that all markets can access.

•2018: New initiatives include *Vitality Invest* and *Discovery Insure Commercial Insurance*. Launching of Discovery for Business, which is aimed at the commercial sector. The launching of Discovery Bank in 2019 is announced.

Discovery's business model and how the company works

Discovery's business model is 'to offer its clients insurance and financial products and services with Vitality at the foundation. This approach benefits businesses, stakeholders and the broader society. Vitality is the key component that enables Vitality Shared-Value Insurance. Helping clients to improve and manage their health, savings, and driving

behaviour, it gives insurance partners the ability to better understand and measure risk. This results in more accurate pricing of premiums as clients continuously improve and engage with their health status, as measured through Vitality. This further encourages positive behaviour change.' [1] Discovery's businesses benefit from improved risk; clients are healthier as they get more value from incentives (such as gym membership, discounts on flights and Apple watches) and savings based on their Vitality engagement, and society benefits from this cycle as well.

Discovery has successfully repeated and implemented its model in a range of adjacent industries and new markets, both in its prime markets in South Africa and the United Kingdom, as well as in global markets. Discovery's portfolio of businesses in South Africa include Discovery Health, Discovery Life, Discovery Invest, Discovery Insure and Discovery Card, and the company plans to add banking to its portfolio in 2019.

In the United Kingdom, Discovery's portfolio includes Vitality Health Insurance, Vitality Life Insurance and Vitality Invest. Vitality Group manages the Group's expansion outside South Africa and the United Kingdom. In China and Australia, Vitality Group formed equity partnerships with Ping An and myOwn Health Insurance respectively, and partnerships and joint ventures with global insurers around the world.

Vitality forms the basis of Discovery's Shared-Value Insurance model, through which Discovery has enabled the world's largest behavioural platform for insurers and other financial services companies to access Vitality.

Source: Adapted from Discovery Integrated Annual Report 2018. Available at https://www.discovery.co.za/marketing/integrated-annual-report-2018/. [Accessed 5 November 2018], pp. 30-31 and p. 36.

Ambition 2018

In 2014 Discovery formulated *Ambition 2018*, with the ambition (vision) for Discovery to 'be the best insurance organisation in the world, one known for our values, innovation and financial strength through our core business activities and a powerful force for social good'.[2] To measure itself against this ambition, Discovery set three criteria delineating its components.

- Social and financial impact: Targets were set for pre-tax earnings, profit growth, return on capital, and the number of members.
- Unique foundation: Achieving a global platform, science and data, a powerful brand, the employer of choice for critical skills and a values-based culture.
- 'Brilliant businesses': The businesses are disruptive in their markets, offer sustainable products, meet complex customer needs, generate excellent member engagement, deliver superior actuarial dynamics and offer an exceptional service ecosystem.

In his 2018 Annual Review, Mr Gore reflected on the company's progress towards achieving *Ambition 2018*, stating that *Ambition 2018* has been an excellent driver of the company's strategy and has led to disciplined models for organic growth, capital and cash management and building a strong portfolio of diversified businesses. He added that the Discovery business model was 'successful in a range of adjacent industries and markets, leading to our strong conviction that it is disruptive and differentiating, and a positive force for good in society'.[3] When the company's performance was measured in all its markets against the stretch targets set for *Ambition 2018*, the company had established a global leadership position; had met the financial and social impact targets; and its businesses were found to be disruptive and differentiating, and performing within expectation.

Control

The company continuously monitors its performance across a range of measures in line with its high-performance culture. The key performance indicators used at the company to measure performance are:

- •strategy measures: market position, new products launched each year and roll-out of the business model;
- •service measures: member perception scores and broker or franchise perception scores;
- •social measures: growth in lives that are impacted;
- •financial measures: normalised headline earnings, embedded value, solvency, return on capital (ROC), core new business API, higher value of Discovery Life and Invest, growth in normalised profit from operations and employee turnover; and
- •people measures: learning and development and the number of people participating in wellness days.

The environment, risks and opportunities

Discovery's operational environment plays a crucial role in its ability to meet performance objectives, but its robust business model is responsive to broad environmental risks and supports its business strategy and performance. The company has clear strategies to manage its risks, to capitalise on the opportunities in its markets, and to set deliverables and requirements that ensure it delivers on its short-, medium- and long-term objectives and targets.

Vision and long-term strategy

Discovery's vision for 2021 is 'to be the world's best insurance organisation and largest behavioural platform through which leading global insurers and companies can access the Vitality Shared-Value Insurance model'.[4] The company's long-term growth strategy is to continue driving strong organic growth by using its repeatable model, supported by its Vitality platform and Shared-Value Insurance model, to expand into new markets and industries and form new partnerships.

Discovery has identified its focus areas for the next three years (to 2021):

- •continue to scale businesses and its model to diversify earnings;
- •in South Africa and the UK, to focus on growing emerging and new businesses, including Discovery Bank and Vitality Invest; and
- •continue to expand the Vitality Group by entering into new partnerships and new markets, while growing existing businesses, and to identify opportunities.

Medium- and long-term goal setting

Discovery's business model and strategy aim to deliver tangible financial benefits for the company. The strategy is implemented through medium- and long-term goal setting plus a robust growth methodology and a sophisticated capital philosophy.

Sources: Gore, Adrian. 2018. Review from Adrian Gore Discovery Chief Executive. In *Discovery Integrated Annual report 2018*. Available at https://www.discovery.co.za/marketing/integrated-annual-report-2018/ [Accessed 5 November 2018]; *Discovery Integrated Annual Report 2018*. Available at https://www.discovery.co.za/marketing/integrated-annual-report-2018/ [Accessed 5 November 2018]; Gore, Adrian. 2017. Review from Adrian Gore Discovery Chief Executive. In *Discovery Integrated Annual Report 2017*. Available at https://www.discovery.co.za/marketing/integrated-annual-report/?page=1.

7.2 The benefits and costs of planning

There is a saying that if you do not know where you want to go, any road will take you there. Managers need to know which way to go and planning provides that direction.

For example, Discovery succeeds, even in a challenging global business environment, because its strategic direction has remained constant. While the organisation evolves over time, the strategy continues to be relevant and has enabled the organisation to consistently deliver good results.

7.2.1 The benefits of planning

Planning has many **benefits**, and the more turbulent the environment, the greater the necessity for planning. How do managers plan for the future in an environment characterised by constant change?

Managers cannot predict the future; the planning exercise cannot change the business environment and no plan can be perfect. However, managers can plan to steer the organisation in the best possible direction, taking into consideration the organisation's internal strengths and weaknesses. Good managers understand that although they are leading the organisation in a predetermined direction, they should anticipate change in the environment, and adjust their goals and plans accordingly when necessary. Since 2008, the world economy has been plagued by many crises, yet some organisations have managed to produce creditable results consistently. How did they do it? Some of the benefits of planning are listed below, and examples from our case study on Discovery illustrate how this global organisation has used the benefits of planning to its advantage, even in the prevailing, challenging business environment.

7.2.1.1 Planning provides direction

The most important function of planning is that it gives **direction** to the organisation in the form of **goals** and **plans**. By establishing where the organisation is heading (goals) and formulating plans to attain these goals, managers ensure that the organisation is both **effective** (providing products or services that the market wants) and **efficient** (providing products and services at the lowest cost).

Consider how planning gives direction in a global organisation such as Discovery. During 2014, the company formulated a bold ambition for 2018, set across three categories with stretch targets for its businesses, its social and financial impact and its unique foundation. The ambition was to be 'the best insurer in the world and a powerful force for social good'.[5] Discovery's core purpose, business model, values, technology platform and brand simultaneously drove its performance during this period. In 2018, Mr Gore, the Group CEO, reported that *Ambition 2018* has been an excellent driver of the company's strategy and has led to disciplined models for organic growth, capital and cash management and building a strong portfolio of diversified businesses.[6]

7.2.1.2 Planning reduces the impact of change

The process of goal-setting and planning is, by definition, future oriented. Managers continually scan the environment to anticipate change that may affect the organisation in the future. They plan for the organisation to benefit from opportunities and to avoid threats, thereby reducing uncertainty, guesswork and the risks caused by change.

In the 2018 Discovery Annual Review, the company identified risk factors in the economic environment of its primary markets, South Africa and the United Kingdom. In South Africa, factors such as a poor growth forecast, inflationary pressures, the depreciating rand and a high unemployment rate contribute to credit default and claims rates from its clients. In the UK, the risk lies in the economic uncertainty surrounding the country's exit from the European Union, coupled with subdued levels of inflation. These factors contribute to low interest rates, which in turn affect Discovery's product pricing. In response to these threats, Discovery diversifies by geography and industry to

help improve its resilience and by providing products that are responsive to the volatility in interest and inflation rates affecting the company and its clients.[7]

7.2.1.3 Planning promotes coordination

Planning focuses all activities in an organisation in one direction: to attain the organisation's goals effectively and efficiently. If all the members of the organisation are aware of the goals they have to meet, they can co-ordinate their activities. This will foster co-operation and teamwork.

Discovery's Global Vitality Network (GVT) illustrates how the company uses advanced technology to co-ordinate aspects of its diversified operations. All the Discovery businesses and partnerships apply the Vitality Shared-Value Insurance model and their assets, programmes, data and brand assets have been centralised in the Global Vitality Network (GVN), using the *Vitality One* technology infrastructure to offer a globally unified systems architecture that all markets can access. The GVN increases opportunities for integration and growth, thus supporting Discovery's broader business strategy.[8]

7.2.1.4 Planning ensures cohesion

The increasing complexity of organisations and the interdependence of all the parts of the organisation (business units, departments, sections, teams and individuals) emphasise the necessity of planning to ensure cohesion. Planning enables top management to see the organisation as a total system in which the goals of all the different parts of the organisation are reconcilable with each other as well as with the primary goals of the organisation as a whole.

The Discovery Shared-Value Insurance model, with Vitality as its basis, underpins all Discovery's businesses, thus ensuring cohesion throughout the company and support for its broader business by increasing product integration and cross-selling opportunities across the company's portfolio of businesses and products.[9]

7.2.1.5 Planning facilitates control

Control is the process by which management ensures that the actual organisational activities are compatible with the predetermined goals and planned activities. Control enables management to measure actual performance against set goals and plans, and to take corrective action if significant deviations occur.

During the planning process, managers formulate organisational goals and plans at various levels of the organisation. These goals and plans later facilitate control. Without planning, control cannot take place.

Discovery, for example, continuously monitors its performance across a range of measures in line with its high-performance culture. The key performance measures the company applies are strategy-, service-, social-, financial-, and people measures (for more details, see case study).[10]

7.2.2 The costs of planning

Despite the obvious benefits of planning, it can also result in the following **costs** to the organisation.[11]

7.2.2.1 Planning may create rigidity

Managers may not be inclined to deviate from set plans, even when changes in the environment may require flexibility in terms of planning.

7.2.2.2 Planning consumes management time

Planning is time consuming and may require a substantial portion of the valuable time and energy of managers.

7.2.2.3 Formal plans may replace intuition and creativity

The formal planning process can turn into a programmed routine and subsequently diminish the vital role of creativity and intuition in planning.

7.2.2.4 Planning could cause delays in decision-making

Planning could shift the focus in an organisation from performing to evaluating, resulting in a delay in making crucial decisions regarding environmental changes that influence the organisation.

7.3 Managerial goals and plans

If you intend to travel from Johannesburg to Cape Town, it would be sensible to buy a map. The map would enable you to set goals for reaching Cape Town. The most important, primary goal would be to reach Cape Town on a specific date. Secondary goals could be that you should reach a town midway to Cape Town to sleep over in before it gets dark on the first day of the journey and that the the cost of the trip should not exceed a specific budgeted amount. In this way, you could formulate several plans to achieve the main goal of reaching Cape Town.

On a personal level, most people are quite familiar with setting goals and formulating plans. The managerial function of planning in organisations is similar, as it comprises the same two components.

First, managers need to ask the question: **Where** do we want this organisation to be at a specific future date? (This will entail setting goals.) Then they need to ask: **How** will the organisation achieve its goals? (This will entail formulating plans.) Thus, the concept of planning incorporates two components: determining the organisation's goals and developing plans to achieve these goals.

Against this background, an **organisational goal** (or objective) can be defined as 'a desirable state of affairs that an organisation aims to achieve at some point in the future'.

An **organisational plan** can be defined as 'the means by which the goal is to be realised'. The concepts of goals and plans are interrelated.

7.3.1 The nature of goals

Organisational goals are the **starting point** of the planning process. Goals **flow directly from** the **organisation's vision** and its **mission statement** but are more specific.

Organisations have **multiple goals**, and the type of goal that is set is influenced by the **organisational level** at which it is set. Goals range from strategic goals formulated by top-level managers to operational goals formulated by lower-level managers.

The **focus of goals** differs because different goals pertain to different aspects of the organisation, such as finances, the environment, participants and survival. Strategic goals are holistic in that they apply to the whole organisation.

The **time period** of goals may be short term, intermediate or long term.

Goals may be **publicly stated** or not. The degree of openness is concerned with whether the goals are official or operative. Official goals are formally and publicly declared (in the annual reports and the media), whereas operative goals represent the private goals of an organisation. Companies listed on the Johannesburg Securities Exchange (JSE) have to make their annual results public because shareholders (people who buy the company's shares on the stock exchange) have a right to know about the financial and managerial state of the companies in which they invest. They do not have

to make public other goals, such as operational and strategic goals relating to, for example, the company's competitive advantage.

7.3.2 The importance of goals

It is crucial for managers to establish where the organisation is heading. Goals are important in this regard for the following reasons:

- Goals provide guidance and agreement on the direction of the organisation, and they steer all the employees and the activities they perform in the same **direction**. Without goals, a business is like a ship without a rudder.
- Clearly formulated, unambiguous goals facilitate effective planning in terms of **resource deployment.**
- Goals can inspire and **motivate** employees, especially if the employees can perceive a specific link between their performance in terms of goal achievement and the rewards they receive.
- Goals provide the basis for the effective **evaluation** of employee and organisational performance, and for the control of organisational resources.

It is clear that effective goal-setting plays a vital part in the success of organisations. To ensure that goals are as effective as possible, they should adhere to specific criteria.

7.3.3 Criteria for effective goals

To improve the chances of successfully achieving goals, managers should ensure that goals are not ambiguous. The **SMART framework** states that goals should be specific, measurable, attainable, relevant and time bound. Managers can follow this framework in order to formulate goals properly:

- When a goal is **specific**, it indicates what the goal relates to, the period to which the goal refers and the specific desired results of the goal.
- When a goal is **measurable**, the goal is stated in such terms that the result can be evaluated objectively and in quantified terms. Managers must be able to see if the goals are satisfied when they compare actual results with predetermined goals. This is especially true for tactical and operational goals. To say, for example, 'market share should be increased' is too vague and not measurable, whereas to say, 'market share should increase by 10 per cent in Gauteng over the next two years, by the financial year end, ending 31 December 2021', is precise and measurable.
- When a goal is **attainable**, it is realistic, yet it should still provide a challenge. Furthermore, managers should assign the responsibility for reaching goals to specific individuals. Each manager generally has responsibilities for setting goals at his or her level in the organisation. This means that the relationship between the expected results and the people responsible for the results should be clearly stated so that managers fully understand the aims and goals, and are in no doubt about what they have to do to achieve them.
- When a goal is **relevant**, it relates to the organisation's vision, mission and strategic goals. It follows that the various goals in an organisation should be compatible with one another because they all derive from the same strategic goals. 'Horizontal consistency' refers to the compatibility of the objectives of various departments with one another. If, for example, the marketing department proposes to extend its line of products, the costs of production will increase, and therefore the production division will find it difficult to embark on cost-cutting as one of its goals. 'Vertical consistency' means that departmental goals are compatible with those of subsections. For example, if marketing sets a target of an 8 per cent increase in sales,

this has to be compatible with the sales objectives set for the geographical markets of the business (in other words, the total increase in sales for the particular regions should add up to 8 per cent).

•When a goal is **time bound**, it has a specific time limit. People are likely to ignore goals with no time limit because there is no sense of urgency associated with them. So, instead of saying, 'increase production by 1 000 units', managers should rather say, 'increase production by 1 000 units by 31 December this year'.

7.3.4 Integrating individual and organisational goals: Management by objectives (MBO)

Management by objectives (MBO) is a technique designed to achieve the integration of individual and organisational goals in organisations. Management by objectives is a system by which managers and employees define goals for every department, project and person, and use them to monitor subsequent performance.

The assumptions underlying the successful implementation of an MBO programme are that it should have the support of top management and that employees should understand the process. All employees must have a clear understanding of the organisation's purpose, vision, mission, long-term goals and strategy. Individual employees' goals derive from the goals of the business unit, department, section, group or team to which they belong, which in turn derive from the organisation's long-term goals.

The process goes as follows:

•The manager and the employee have an **initial discussion** that results in the formulation of a clear job description and key performance areas for the employee.

•The employee establishes potential **key performance targets** in the predetermined areas of responsibility for a forthcoming period. The employee and the manager meet to develop a set of goals for the employee to which both are committed.

•The employee and manager mutually establish **checkpoints** to measure the employee's progress.

•**Evaluation** of the degree of goal attainment takes place at the end of the predetermined period. The evaluation focuses on the analysis of the achieved results compared with the predetermined goals.

An advantage of management by objectives is that managers and employees at all levels of the organisation focus their efforts on the attainment of organisational goals. The process links individual goals to organisational goals and if implemented correctly, it can have a motivational effect on employee performance and thus on the overall performance of the organisation. However, it can do more harm than good when it is reduced to an annual process of filling in forms, which are then filed and forgotten, as this has a negative effect on employee motivation. Good personal relationships between managers and employees are a prerequisite for the successful implementation of the process.

7.3.5 The nature of plans

While a goal is a desired future state that the organisation attempts to achieve, a plan shows what must be done to achieve organisational goals. It indicates how the organisation plans to reach its goals by specifying the resources that will be used, the period in which the plans must be implemented and all the other actions that will be necessary to achieve the goals.

When formulating plans to achieve the organisation's goals, managers consider several alternative plans of action and ultimately select the best alternative (or alternatives) to achieve the predetermined goals.

Various factors influence managers when they develop alternative plans, such as external factors, the organisation's strengths and weaknesses, and the costs associated with plans.

External factors, such as market factors, legislation or economic trends, influence the business environment and subsequently the ability of the organisation to achieve its goals. Such environmental influences occur in the form of opportunities to exploit or threats to avert (see Chapter 4 on environmental scanning). Managers consider these opportunities and threats when making alternative plans.

Managers also take cognisance of the strengths and weaknesses in the organisation's internal environment when they develop alternative plans. They aim to capitalise on the organisation's strengths, such as particular skills, a patent, capital, the image of the organisation, possession of a unique raw-material source or a marketing channel. At the same time, plans should not expose the weaknesses of the organisation to threats in the environment.

Managers weigh the costs of alternative plans against their respective advantages and through this process develop rational plans.

7.4 The planning process

7.4.1 The planning context

Several factors determine the **context** in which planning takes place. These variables set the parameters within which managers can formulate realistic organisational goals and plans. Managers cannot set goals and make plans that are unattainable in terms of either the environment in which the organisation operates or the resources at the disposal of the organisation. For example, the corner café cannot have a goal such as 'to gain 50 per cent of the market share in selling groceries in Soweto this year'. Such a goal is unrealistic in terms of the café's planning context. On the other hand, Discovery's growth strategy for 2021 to expand into new markets and adjacent industries, and to form new partnerships, is realistic and feasible.

The five variables that set the parameters for organisational planning are: the purpose of the organisation and the environment; the organisation's mission statement; the organisation's environment; the managers' values and the managers' experience.

The **purpose** of the organisation includes its obligation to society (for example, providing safe products at reasonable prices) and its obligation to its stakeholders (for example, to make a profit) or a combination of these factors.

As explained in the case study at the beginning of the chapter, Discovery's business model is based on the Vitality Shared-Value Insurance model, which underpins the company's purpose of making people healthier and enhancing and protecting their lives. This purpose is the driver of the company's corporate-level and business-level strategies.

The **mission statement** sets out the unique purpose that distinguishes the organisation from other organisations of its type. The mission statement, derived from the vision of the organisation, guides the goal-setting and planning in organisations.

The **environment** is one of the most crucial variables that influences planning. In Chapter 4, it was emphasised that organisations are open systems that have specific interactions with their environments. To survive, organisations must plan to take

advantage of external opportunities and to avoid threats in the environment. During the strategic-planning process, organisations set strategic goals and formulate strategic plans to reconcile their internal strengths and weaknesses with external opportunities and threats. Managers at different levels of the organisation transform the strategic goals and plans into tactical and operational plans, as well as individual goals and plans.

Values influence and cement the organisation's culture, strategy and structure. They also determine the organisation's commitment to social responsibility. The values of Discovery appear in the box below.

Values of Discovery Limited

- Business astuteness and prudence
- Innovation and optimism
- Great people
- Liberating the best in people
- Integrity, honesty and fairness
- Intellectual leadership
- Tenacity, urgency and drive
- Dazzle clients

Source: Our business model. In *Discovery Integrated Annual Report 2018*. Available at https://www.discovery.co.za/marketing/integrated-annual-report-2018/. [Accessed 1 November 2018], p. 30.

The **experience of management** is vital because it influences the planning performance of managers.

In the case of Discovery, Mr Adrian Gore, a founding member of Discovery in 1992 and an actuary by profession, is still at the helm of the company as the Group Chief Executive Officer 26 years after its inception. Mr Gore is one of South Africa's top entrepreneurs, and he is globally recognised as an innovative thinker on how wellness and behavioural change integrate with health, life, insurance and motivating people by giving them incentives to look after themselves.[12]

7.4.2 Steps in the planning process

Planning is a process. By expanding on the example of travelling from Johannesburg to Cape Town, the planning process becomes apparent.

If your goal is to travel by car from Johannesburg to Cape Town, many roads will lead you there, and you can therefore develop different alternative plans (Johannesburg–Durban–Cape Town, Johannesburg–Beaufort West–Cape Town or Johannesburg–Knysna–Cape Town, for example). However, associated with each route are specific variables that can help to make one of the options more attractive than the others. For example, travelling from Johannesburg to Cape Town via Beaufort West is much shorter than travelling from Johannesburg to Cape Town via Durban. To travel via Knysna to Cape Town is another option, but while this route is scenic, there are cost and time implications.

You must decide on a plan within a certain planning context – for example, you have only two days to get to Cape Town, and your budget allows you a specific amount to pay for the trip (including petrol, accommodation and food). To reach a decision, you will evaluate each of the alternative plans in terms of the planning context and other criteria, such as the dangers of travelling on South African roads in the dark.

After evaluating all the alternatives, you can select the best plan (travelling via Beaufort West in two days). The next step is to implement the plan by booking a service

for your car a week before the trip and making a reservation to sleep over somewhere halfway through the trip.

The final step is to travel to Cape Town, sleeping over in a town midway, Colesberg. However, in the morning before leaving Colesberg, a traffic report on the radio warns motorists that the road to Beaufort West is closed owing to flooding. In such an eventuality, you need to implement an alternative plan and change your route by travelling to Cape Town via Graaff-Reinet instead of Beaufort West.

This example illustrates that planning comprises a number of steps, which follow each other in a specific sequence, thus forming a process. The steps in the planning process are:

- Establish **goals** (e.g. reach Cape Town on a specific date).
- Develop **alternative plans** (e.g. different routes to Cape Town).
- **Evaluate** alternative plans (e.g. using criteria such as cost, time and so on).
- **Select** a plan (e.g. Johannesburg–Beaufort West–Cape Town).
- **Implement** the plan (e.g. service car, make reservations, drive to Cape Town).
- Do **reactive planning**, if necessary, when changes occur in the environment (e.g. change plan and travel via Graaff-Reinet).

Figure 7.1 illustrates the planning process.

Although all managers follow the same steps of the planning process, as illustrated by the simple example of travelling from Johannesburg to Cape Town, each **level of management** has a different planning focus:

- **Top-level** managers formulate long-term strategic goals and strategic plans for the entire organisation.
- **Middle-level** managers use strategic goals and strategic plans as inputs to develop medium-term tactical goals and tactical plans for their functional departments.
- **Lower-level** managers use tactical goals and tactical plans to develop short-term operational goals and operational plans for their sections.

Figure 7.1: The planning process

Figure 7.2 illustrates the planning process as goals and plans cascade down from the strategic level to the operational level.

Figure 7.2: The levels of goals and plans and their time frames

7.4.3 Strategic goals and plans

The first half of the 20th century was characterised by stable business environments with low and stable rates of interest, few raw-material shortages, a slow and steady rate of technological innovation, and a general economy in which inflation was practically unknown. In such a stable environment, organisations were able to sell their products or services without being too concerned about planning for the future. The assumption was that future environments would be more or less the same as prevailing ones, so that a mere extension or projection of previous plans was adequate to ensure profitable survival.

However, since the 1950s, the business environment has been changing at an unprecedented rate. Managers have had to look for new approaches because old ones have proved to be of little use in an unstable environment. At the same time, organisations have become larger and more complex. During the late 1950s, organisations started to do long-term planning in an attempt to take countermeasures against instability in the business environment. In the 1960s, and especially in the 1970s, strategic planning became a popular tool used by organisations in an effort to keep abreast of change in the business environment and to develop longterm or strategic plans.

Today, organisations ranging from government departments and not-for-profit organisations to global organisations use strategic planning to help them operate in the current complex, global business environment.

Major technological advances in various fields indicate that the world is at the beginning of a Fourth Industrial Revolution, a new era that builds and extends the impact of digitisation in novel and unanticipated ways. The World Economic Forum describes the Fourth Industrial Revolution as the advent of 'cyber-physical systems' involving entirely new capabilities for people and machines.[13]

These capabilities represent new ways in which technology becomes embedded within societies. Examples include genome editing and new forms of machine intelligence, for example, self-driving cars and drones. The technology related to the 'digitisation of matter' will advance rapidly, for example the creation of objects, such as cars and houses, as well as human tissue, bones and custom prosthetics by 3D printers. New technology will soon integrate computers into clothing. Within the next few years, clothes connected to the Internet will be available, such as sports shirts providing the wearer with real-time workout data by measuring sweat output, heart rate and breathing intensity. Furthermore, new approaches to governance, relying on cryptographic methods, for example, the blockchain (the shared database technology where transactions in digital currencies such as the Bitcoin are made) are emerging.[14]

Organisations worldwide are witnessing the major impact of new technology in their industries. On the demand side, organisations have to change the design, marketing and distribution of their products and services to adapt to new patterns of consumer behaviour and engagement, which is a consequence of consumers' access to mobile networks and data. On the supply side, the introduction of new technologies by agile, innovative competitors disrupt existing industry value chains by using global, digital platforms for research and development, marketing and distribution to supply their customers with better quality products, faster and cheaper.[15] Discovery is an example of an organisation that is disruptive and differentiating in the industries where it operates. Through its Shared-Value Insurance model, with Vitality as its basis, Discovery has enabled the world's largest behavioural platform which insurers and financial services organisations use to access Vitality (see case study). The company is currently in the process of adding a central research and development function to its Global Vitality Network (GVN).

Crucial skills that are required within organisations in the context of the Fourth Industrial Revolution are creativity and imagination, strategic and critical thinking skills, problem-solving skills and agile leadership skills.[16]

7.4.3.1 Strategic goals

Top managers formulate strategic goals that apply to the organisation as a whole over the long term. Strategic goals include a vision, a mission statement and long-term goals.

A **vision** implies that managers need to think about new possibilities that will carry their organisations into the future. When asked what his job as Group CEO of Discovery involves, Mr Gore answered that his job is to create a vision, hope and inspiration for the organisation.

A vision also promotes change and provides the foundation for a strategic plan. The vision is a picture of the future the organisation seeks to create. Organisations with clear vision statements generally outperform organisations without a vision. When there is a clear vision, decision-making focuses on the important issues, and individuals are motivated because they can see how their efforts contribute to the success of the organisation.

As described in the Discovery case study, the company's vision for 2021 is 'to be the world's best insurance organisation and largest behavioural platform through which leading global insurers and companies can access the Vitality Shared-Value Insurance model'.[17]

The **mission statement** spells out the mission or overarching goal of the organisation. The mission statement sets the organisation apart from other organisations operating in the same industry by defining it in terms of its unique combination of products, customers and technology. In the mission statement, the organisation answers three important questions:

1. What is our business (products and services)?
2. Who are our customers (markets)?
3. How do we provide our products or services (technology)?

The mission statement may also include the organisation's intention to secure its survival through sustained growth and profitability. In addition, the organisation may use it to make a statement about the organisation's culture, public image, self-concept, social responsibility and the quality of its products. The mission statement sets the stage for strategic, tactical and operational planning in the organisation.

Discovery, for example, uses its unique Vitality Shared-Value Insurance model to offer insurance and financial **products and services** across its businesses in South Africa and the United Kingdom and in 19 countries (in 2018) worldwide (**market**). Discovery uses behavioural economics, clinical data and actuarial data as their **technology** (see case study).

Its product, markets and technology sets Discovery apart from other organisations competing in the finance and insurance markets.

Long-term strategic goals derive from the organisation's vision and mission statement. They are complex and deal with the organisation as a whole. While their focus is long term, the exact period may vary from organisation to organisation, depending on the industry.

In considering long-term goals, top managers usually include goals in such critical areas as profitability, productivity, competitive position, human resources development, human relations, technological leadership and social responsibility.

Strategic goals should be clear, since tactical goals derive from them.

An example of how organisations use long-term strategic goals is evident from Discovery's *Ambition 2018*. The company set stretch targets for its businesses, its impact and its foundation. The success of attaining these goals was measured against specific metrics: financial and social impact, brilliant businesses and a unique foundation (see case study for more detail about these metrics).[18]

7.4.3.2 Strategic plans

In order to achieve the organisation's strategic goals, top managers develop strategic plans. These plans focus on the organisation as a whole and not on a specific function or operation, although the ultimate aim is to create synergy.

Top managers tasked with developing strategic plans have access to the necessary information about the organisation and its business environment. While formulating the strategic plans, these top managers interpret the opportunities and threats in the business environment and determine their potential impact on the organisation. The process requires managers to think conceptually, integrating the consequences of alternative strategic plans with the needs and resources of the organisation in order to create a **competitive advantage.**

Strategic plans usually refer to a period of more than five years, but this depends on the industry in which the organisation operates. Strategic plans filter down in the organisation to form the basis for tactical plans, and subsequently for operational plans.

GENERIC STRATEGIES

The selection of a **generic strategy** entails the core idea about how the organisation plans to compete in its market or markets. Generic strategies include strategies concentrating on **cost leadership** (capitalising on sales and keeping costs as low as possible), **differentiation** (differentiating its products or services from those of its competitors), **focused low-cost strategy** (providing products or services at the lowest costs in a specific market segment) and **focused differentiation** (differentiating its products and services within a specific market segment).

CORPORATE STRATEGIES

Corporate (grand) strategies address two aspects: (1) identifying in which, and in how many businesses and industries the organisation wishes to compete, and (2) how the organisation can build synergy and competitive advantage among business units.

The driver of strategy at the corporate level (and also the strategies at the individual business level) is the **purpose** of the organisation. Corporate strategies provide the direction on how the organisation aims to attain its strategic goals. Corporate strategy determines whether the organisation will expand its present business or businesses, buy or start other businesses (**internal and external growth strategies**), reduce operations by selling or closing parts of the business (**turnaround or decline strategies**) or use **corporate combination strategies**. The following are examples of **corporate growth strategies:**

INTERNAL GROWTH STRATEGIES

- *Market development*. The organisation plans to develop existing markets for its present products more intensively or to develop new markets for existing products. In the latter case, the organisation considers new regions or the global market. The technology and products remain the same.
- *Product development*. The organisation develops new products for existing markets or modifies existing products to win greater approval among consumers. The market and technology remain the same.
- *Concentration growth*. The organisation directs all its resources and skills to the profitable growth of a single product in a single market. In short, the organisation concentrates all that it has on what it does best to realise its mission.
- *Innovation*. The organisation constantly improves products or services. It refers to the development of new products or services to take advantage of the initial high

profitability of a better product or service, or using new technology in a specific industry.

EXTERNAL GROWTH STRATEGIES

•*Integration*. A *horizontal-integration* strategy implies that the organisation takes over organisations similar to it because it wants to increase its market share, or scale. This strategy gives the organisation access to new markets and gets rid of competition. In the case of a *backward vertical-integration* strategy, the organisation moves closer to its sources of supply by acquiring an organisation or organisations that supply it with critical resources, such as raw material or a distribution channel. *Forward-vertical integration* involves the acquisition of a business closer to the end consumer of the organisation's products or services, for example an oil company opening service stations selling its petrol.

•*Diversification*. An organisation follows this strategy when it acquires other organisations and so enters into new activities, or when it sets up a completely new entity. This strategy spreads risk, results in synergy and can achieve quicker growth or higher profits. *Related diversification* refers to an organisation acquiring another organisation or organisations related to it in terms of market, product or technology. *Unrelated diversification* refers to an organisation acquiring another organisation or organisations unrelated to it in terms of product, market or technology.

CORPORATE COMBINATION STRATEGIES

•*Merger*. A **merger** takes place when two or more organisations pool their resources to form a new organisation.

•*Acquisition*. An **acquisition** takes place when one organisation, the parent organisation, acquires another organisation, or parts of the organisation (the target organisation), for cash or equity in the parent organisation. If the management of the target organisation rejects the acquisition offer, the parent company can approach the shareholders in the target company to buy their shares and thus 'take over' the organisation in a hostile fashion.

•*Joint venture*. When two or more organisations join and use some of their resources to form a separate, new business, in which both share ownership, they form a **joint venture.**

TURNAROUND OR DECLINE STRATEGIES

•*Turnaround*. An organisation follows a **turnaround** strategy during difficult times, when its profits are declining, compelling it to cut costs by terminating unprofitable products, getting rid of unprofitable assets and, in particular, improving ineffective management.

•*Asset reduction*. An **asset reduction** (or harvesting strategy) is implemented when an organisation wishes to maximise cash flow in the short term (regardless of the long-term effect of such a strategy) by disposing of a subsidiary that has delivered its maximum returns to the organisation.

•*Divestiture*. A **divestiture** strategy usually involves selling a business or parts of it in line with its mission.

•*Liquidation*. An organisation chooses a **liquidation** strategy when it admits failure and wants to keep shareholders' losses to a minimum.

The Discovery case study contains many examples of how the organisation strategises. Above all, its strategic direction is driven by its **core purpose**. Since inception, the company's core purpose is 'to make people healthier and enhance and protect their lives'.[19] The focus of the company on its purpose has resulted in a business model geared to creating shared value which it implemented in its primary markets and globally. [20] In line with this purpose, Discovery has built a **portfolio** of 'brilliant' businesses'.

Discovery's generic strategy is **differentiation** (differentiating its products or services from those of its competitors).

Discovery's **growth strategy** in its primary markets, South Africa and the United Kingdom, is to focus on growing emerging and new businesses, including Discovery Bank and VitalityInvest. In the Vitality Group, the strategy is to expand into adjacent industries and new markets, and form new partnerships by implementing its Shared-Value Insurance model.[21]

A strategic focus of Discovery is to launch **new products** each year that meet complex consumer needs and that are sustainable. For example, during 2017–2018, a product offered by Discovery Life, the Global Education Protector, was recognised as one of the most innovative life insurance products globally.[22]

Discovery has received wide global recognition for **innovation** in insurance, for example, a report released in 2017 at the World Economic Forum in Davos named Vitality Group a leading health innovator. Boston Consulting Group named Discovery as one of the leaders in digital innovation that has built ecosystems using digital technology to fill market voids, and is continuously innovating with a customer-centric focus. [23]

Discovery uses its model to build a strong portfolio of **diversified businesses** in the healthcare, life insurance, short-term insurance, savings and investment, wellness and banking markets. [24] The company diversifies by geography and industry.

Discovery expanded into China by acquiring a 25 per cent share in Ping An Health Insurance Company of China Ltd, a wholly-owned subsidiary of Ping An Insurance (Group) Company of China.[25]

Through Vitality Group, Discovery forms partnerships and **joint ventures** globally to implement the Vitality Shared-Value Insurance model. Examples of Discovery's equity partnerships, through Vitality Group, include Ping An Health in China and myOwn in Australia. The company forms partnerships and joint ventures throughout the world with leading global insurers. [26]

7.4.4 Tactical goals and plans

Strategic goals and plans serve as inputs for middle managers to formulate tactical goals and plans (also called functional goals and plans). Tactical goals and plans are set at the level of middle management by the managers in each functional area. Tactical goals and plans focus on how to carry out those tasks necessary for the achievement of strategic goals.

7.4.4.1 Tactical goals

Tactical goals are medium-term or short-term goals derived from the long-term goals. For example, in order to increase market share from 10 per cent to 20 per cent over the next five years (a long-term goal), sales in an organisation will have to increase by 18 per cent a year and the organisation will need additional resources (medium-term or tactical goals).

7.4.4.2 Tactical plans

Tactical plans have a more specific focus when compared with strategic plans because they deal with people and actions. Middle-level managers who are department heads (such as marketing managers or operations managers) formulate medium-term plans for their various functional areas to realise tactical goals.

Tactical plans take into consideration strategic goals and plans, tactical goals, resource allocation, time issues and human-resources commitments.

Table 7.1 shows examples of tactical or functional plans.

Table 7.1: Tactical or functional plans

Functional management areas	Key aspects to be considered
Marketing	Product line, market position, distribution channels, market communication and price
Finance	Policy on debtors, dividends, asset management and capital structure
Production and operations	Productivity, locations and legislation issues
Human resources	Labour relations, labour turnover, training of human resources and equity and divers
Procurement	Suppliers, policy on creditors and sources of raw materials
Research and development	Develop new products and improve existing products and services, information tech communications
Public relations	Liaise with stakeholders inside and outside the organisation to promote good relatio
Information technology	Maintain internal and external communication networks with employees, suppliers, c customers and the public

7.4.5 Operational goals and plans

Middle-level and lower-level managers develop operational goals and plans.

7.4.5.1 Operational goals

Operational goals (or short-term goals) refer to a period of no longer than one year. Operational goals deal with the day-to-day activities of an organisation and the allocation of resources. They take the form of unit goals and operational standards. Operational plans are executed by first-line managers.

7.4.5.2 Operational plans

Operational plans (or short-term plans) refer to a period of no longer than one year. The purpose of operational plans is to achieve operational goals. Two basic forms of operational plans are single-use plans and standing plans.

Single-use plans are developed to achieve a set of goals that are not likely to be repeated in future. Programmes, projects and budgets are single-use plans:

- A **programme** entails a set of plans for attaining a one-time organisational goal. An example of a programme is the building of a new office block.
- A **project** also entails a set of plans for attaining a one-time organisational goal, but it is smaller in scope and complexity than a programme. It is often part of a larger

programme. An example of a project is the installation of the air-conditioning system for a new office block.

- A **budget** is a numerical plan for allocating financial, human, physical and informational resources to specific activities.

Standing plans are ongoing plans that provide direction for tasks that are performed repeatedly in the organisation. Policies, rules and standard procedures are standing plans:

- **Policies** are broad in scope and are derived from the organisation's overall goals. Policies define the boundaries for decision-making to ensure that decisions are consistent with the organisation's goals. Examples of policies are: 'The customer is always right' and: 'We pay our employees competitive wages'. They are broad guidelines on managerial action. First-line managers rarely make policies. Instead, they interpret and apply them. Managers must use their judgment within the limits set by policies. For instance, a policy of: 'We pay competitive wages to our employees' does not tell a manager what to pay a new employee. However, if the industry rate for the specific job is in the R170–R250 per hour range, the policy would clarify that offering an hourly starting rate of either R100 or R400 is not acceptable.
- A **rule** is a statement that prescribes to employees what they may or may not do in a specific situation. Managers often use rules when they confront a recurring problem, to ensure consistency. For example, rules about lateness or absenteeism permit managers to make disciplinary decisions quickly and fairly.
- **Standard procedures** and methods define a precise series of steps for attaining certain goals. Examples are procedures for handling employees' grievances and methods of issuing refunds.

7.5 The implementation of plans

Implementing the chosen plan involves developing a framework for its execution, leadership to set the plan in motion, and the exercise of control to determine whether the performance of the activities is going according to plan. If there is a deviation from the plan, control will reveal this and **reactive planning** will be necessary. This implies that managers may need to reconsider the goal and the resources required in order to fit the new information about the environment.

7.6 Summary

Planning is the starting point of the management process. It determines the 'what' and 'how' of organisational activities. The 'what' of planning refers to the various goals of the organisation and the 'how' of planning describes the organisation's plans to achieve these goals. Goals and plans can be strategic, tactical or operational, and the period they refer to can be long term, medium term or short term respectively. To implement the plans, managers organise, lead and control organisational resources to achieve the long-term, medium-term and short-term goals of the organisation. The next three chapters deal with the functions of organising, leading and control.

Small business perspective: The planning function in small business organisations[27]

Planning is the first step to determine the future course of action for the small business organisation. Planning provides the map of where the small business is heading (goals) and

how it will get there (plans). The purpose of planning for a small business is to provoke the interest of potential investors and guide the owner or managers in operating the business. It serves to attract customers and prospective employees. The types of plans that will improve a small business's chances of survival include strategic plans before starting the business, a formal business plan to attract investors and prospective employees and continuous operational planning and control before and after the business starts operating.

Strategic planning for the small business provides the long-term direction of the business and shorter-term objectives and plans to reach the long-term objectives.

The **business plan** is a formal plan and a tool to raise money. It contains a detailed outline of the activities a new small business needs to perform to finance the business, develop the product or service, and then market it and manage it. A well-developed business plan can provide small business owners with a much greater chance of success.

Business Partners, formerly known as the Small Business Corporation, is an organisation launched by the late Anton Rupert and his son Johan Rupert in the 1980s. The company facilitates entrepreneurship through a comprehensive service offering of business finance, mentorship and business premises to entrepreneurs in the small and medium enterprise (SME) environment. The core of its focus is providing the entrepreneur with finance for their formal business. Business Partners structures unique, individualised financing solutions using shareholders' loans, equity, royalties and term loans – or any combination of these. Before parting with its money, Business Partners requires from an entrepreneur a solid business plan and cash flow viability. It also assesses the technical and managerial skills, integrity and commitment of the entrepreneur. [28]

Operational planning entails setting policies and procedures as well as budgets, which provide the basis for operating the business. These plans include selecting a location, planning operations and physical activities, planning for and securing sources of supply for goods and materials, planning for human resources requirements, setting up the legal structure and the organisational structure, determining the organisation's approach to the market, establishing an efficient records system, and setting up a time schedule. A crucial aspect of planning in small business organisations is financial planning, which comprises a projection of income and expenses and the initial investment required, and identifying possible sources of funds. Financial planning is vital to insure the feasibility and success of the small business.

KEY TERMS	
attainability	operational goals and plans
budget	organisational values
business strategy	planning context
concentration-growth strategy	policies
corporate strategy	product-development strategy
diversification strategy	programme
divestiture strategy	purpose
environment	relevancy
generic strategy	rule

horizontal-integration strategy	single-use plan
implementation of plans	specificity
innovation strategy	standard procedure
joint-venture strategy	standing plan
liquidation strategy	strategic goals and plans
management by objectives	tactical goals and plans
managers' experience	time bound
market-development strategy	turnaround strategy
measurability	vertical-integration strategy
merger	vision
mission statement	

Questions for discussion

Reread the case study at the beginning of this chapter and answer the following questions:

1. Which examples from the case study illustrate the benefits of planning?
2. What is the difference between goals and plans?
3. Discuss the nature of goals and find examples in the case study of the various characteristics of goals.
4. Explain what the planning context entails and use examples from the case study to explain the planning context of Discovery.
5. Find and discuss examples of strategies followed by Discovery that were not discussed elsewhere in this chapter.

Multiple-choice questions

Lower-level, middle-level and top-level managers perform the same management functions, but the focus of their activities is different. Consider the following statements and answer Questions 1, 2 and 3:

i. Focus on creating and maintaining a competitive advantage for the organisation.
ii. Develop plans focused on functional areas.
iii. Focus planning narrowly with short time horizons.
iv. Perform the management functions of planning and control.
v. Create a vision of the future for the organisation.
vi. Use standing plans.
vii. Use information that is specific and quantitative when planning.

viii.Set tactical goals.
ix.Focus on the entire organisation.
x.Implement strategic plans.

1.Statements _________ describe the work of lower-level managers.

a.i, iv, v, ix
b.ii, iv, vii, x
c.iii, iv, vi, vii
d.iv, v, vi, vii

2.Statements _________ describe the work of top-level managers.

a.i, iv, v, ix
b.ii, iv, vii, x
c.iii, iv, v, vi
d.iv, v, vi, vii

3.Managers can follow the SMART framework to formulate _________ properly.

a.goals
b.a vision
c.a mission statement
d.plans

4.Which of the following is a standing plan?

a.programme
b.project
c.policy
d.budget

5.Which of the following is not a corporate combination strategy?

a.merger
b.acquisition
c.asset reduction
d.joint venture

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CHAPTER 8

Organising

Tersia Botha

The purpose of this chapter

Once management has devised a plan to achieve the organisation's goals, it must deploy resources such as people, equipment, money and physical resources. In addition, it must design jobs; assign tasks, duties and responsibilities to people; co-ordinate activities; and establish lines of communication and reporting. This is called organising. The purpose of this chapter is to examine organising as the second fundamental function of management. An overview of the importance of organising is provided, followed by an examination of the fundamentals of organising. An exposition is given of how an organisation evolves from a one-person business to a large business organisation with many departments. Authority relationships as well as reporting relationships are explained, and thereafter co-ordination is discussed. A brief overview of the informal organisation is also given. Finally, the factors influencing the design of an organisation's structure are discussed, and it is emphasised that such a structure must enable the people concerned to work effectively towards the organisation's mission and goals.

Learning outcomes

On completion of this chapter you should be able to:

- explain the concepts of organising and organisational structure
- describe the importance of organising
- discuss the fundamentals of organising
- explain how an organisation evolves from a single-entrepreneur organisation to a large one
- present viewpoints regarding the factors that influence organising.

8.1 Introduction

Planning, the first fundamental function of the management process, is defined as the setting of goals and the development of a plan of action to achieve the goals as productively as possible. Thus, planning requires managers to decide where the organisation should go in future and how to get it there. Planning, however, is only one function of the management process, and it alone cannot guarantee that the goals of the business organisation will be accomplished. Once the plan to achieve certain goals has been selected, management must combine human and other resources, such as money, machines, raw materials and information or knowledge, in the best possible way to achieve the organisation's goals. The most important of these is the task of grouping people into teams, functions or departments to perform the activities that will convert the plan into accomplished goals. In the Edcon case study that follows, note the grouping of people and other resources in three divisions: the Edgars, Jet and Speciality divisions. The structured grouping and combining of people and other resources, and co-ordinating them to achieve organisational goals, constitute the second fundamental element of management: organising.

Organising means that management has to develop mechanisms in order to implement the strategy or plan. Organising can be defined as the process of delegating

and co-ordinating tasks, activities and resources in order to achieve organisational objectives. The organising process's point of departure is the vision, mission, goals and strategies of the organisation. Arrangements have to be made to determine which activities will be carried out, which resources will be employed, and who will perform the various activities in order to achieve the organisation's vision, mission and goals. This involves the distribution of tasks among employees, the allocation of resources to persons and departments, and giving the necessary authority to certain people to ensure that the tasks are in fact carried out. Above all, there must be communication, co-operation and **co-ordination** between the people and the departments or sections performing the tasks. Lastly, a control mechanism should be put in place to ensure that the chosen organisational structure does, indeed, enable the organisation to attain its vision, mission and goals.

The organising process leads to the creation of an **organisational structure**, which defines how tasks are divided and resources are deployed. Organisational structure can be defined in the following three ways:

- The set of formal tasks assigned to individuals and departments;
- Formal reporting relationships, which include the lines of authority, responsibility, the number of hierarchical levels and the span of management's control; and
- The design of systems to ensure effective co-ordination of employees across departments.

Ensuring co-ordination across departments is just as critical as defining the departments to begin with. Without effective co-ordination systems, no organisational structure is complete.

The set of formal tasks and formal reporting relationships provides a framework for the vertical control of the organisation. The characteristics of vertical structure are portrayed in the organisation chart, which is the visual representation of an organisation's structure.

In a newly established business, decisions have to be made about equipment, supplies, processes to be followed and the people who must perform the tasks. In addition, the structure indicating the distribution of tasks among departments and individuals has to be drawn up, indicating the responsibilities and lines of authority and communication. In an existing business, organising has to be constantly reviewed and adapted to accommodate new strategies, new products and new processes, or any organisational changes that affect the activities. In line with the strategy or plan, management still arranges what needs to be done so as to reach the objectives.

The case study that follows illustrates how the principles of organising are applied to a real-life situation in South Africa.

CASE STUDY: Organising in action: Edgars Consolidated Stores Ltd (Edcon)

Since its founding in 1929, Edgars Consolidated Stores Ltd (Edcon) has established itself as one of the leaders in South Africa's clothing, footwear and textile retail arena. Edcon's retail businesses are structured (or organised) into three divisions, namely:

1. The Edgars division which serves principally middle- and upper-income markets.
2. The Jet division, including Jet and JetMart and which serves principally middle- to lower-income markets.
3. The Speciality division, including Edgars Active, Boardmans, CNA, Red Square, and the various mono-branded stores.

In 2017, various macro-economic changes globally, and in South Africa in particular, affected Edcon. The real gross domestic product has declined on a year-to-year basis. The unemployment rate in the country declined to 27,5 per cent in the third quarter of 2018.[1] Furthermore, the rand/US$ exchange rate has weakened, and the private sector

credit extension rate (on a year-to-year basis) also deteriorated. All of these factors have had a negative effect on the disposable income of consumers, creating tight credit conditions, low consumer confidence, a more restrictive fiscal policy and increased competition. These factors have, in turn, led to a huge decline in retail sales, forcing the company to adapt their strategies and structures. For example, Edcon's balance sheet post 1 February 2017 was no longer laden with debt. They have introduced new ownership, appointed a new board, and sold the Legit business (including Botswana) effective 29 January 2017. The changes in strategy were followed by changes in structure. Edgars Shoe Gallery was closed, the company exited non-profitable international brands, and store cost savings were achieved through the closure of non-profitable trading stores. The company also introduced a merchandise strategy of rationalising suppliers, rationalising their product range, introducing fresher inventory and more competitive pricing. This has improved their customer franchise. An increase in the company's retail gross profit margin and retail gross profit was achieved by better input costs, improved negotiated supplier rebates and discounts as well as a reduction in clearance and promotional markdown.

Source: Compiled from information in Edcon. 2017. Unaudited consolidated results. Q4 and full year 2017. Available at www.edcon.co.za/pdf/announcements/2017/2017/Q4FY17-Investor-pres-entation-latest.pdf [Accessed 18 November 2018].

8.2 The importance of organising

Organising, like planning, is an integral and indispensable component of the management process. Without it, the successful implementation of plans and strategies is not possible because of the absence of a systematic, effective and efficient allocation of resources and people to execute the plans. Leadership and control are not possible if the activities of management and employees are not organised, or if the business does not clearly designate the individuals responsible for specific tasks.

The reasons for the importance of organising in an organisation include the following points:

- Organising entails a detailed analysis of work to be done and resources to be used to accomplish the aims of the business. It is through organising that tasks and resources, and methods or procedures, can be systematised. Everyone should know their duties, authority and responsibility, the procedures they must follow or the methods they have to adopt, and the resources they can use. Proper organising ensures that the joint and co-ordinated efforts of management have a much greater and more effective result than the sum of individual efforts.
- Organising divides the total workload into activities that can comfortably be performed by an individual or a group. Tasks are allocated according to the abilities or qualifications of individuals, thus ensuring that nobody in the business has either too much or too little to do. The ultimate result is higher productivity.
- Organising promotes the productive deployment and utilisation of resources.
- Related activities and tasks of individuals are grouped together rationally in specialised departments, such as marketing, personnel or finance departments, in which experts in their particular fields carry out their given duties.
- The development of an organisational structure results in a mechanism that co-ordinates the activities of the whole business into complete, uniform, harmonious units.

Successful organising, then, makes it possible for a business to achieve its goals. It co-ordinates the activities of managers and their employees to avoid the unnecessary duplication of tasks, and it obviates possible conflicts. It also reduces the chances of doubt and misunderstandings, enabling the business to reach its goals efficiently.

Against this background, an examination of the building blocks or the fundamentals of organising follows.

8.3 The fundamentals of organising

Building an organisational structure revolves around the building blocks or the fundamentals of organising. There are five building blocks or fundamentals of organising that managers can use in constructing an organisation:

1. Designing jobs
2. Grouping jobs (departmentalisation)
3. Establishing reporting relationships
4. Establishing authority relationships
5. Co-ordinating activities.

8.3.1 Designing jobs

The first building block of organisational structure is **job design** (job analysis, design and specialisation are discussed in more detail in Chapter 11). Job design is the determination of an employee's work-related responsibilities. The job design and description of a sales manager of the Edgars division of Edcon, for example, would give a detailed exposition of sales objectives per week, per month and per year.

The point of departure when designing jobs for employees is to determine the level of **specialisation** or the degree to which the overall task of the organisation is broken down into smaller, more specialised tasks. Specialisation is the way in which a task is broken up into smaller units to take advantage of specialised knowledge or skills to improve productivity. **Job specialisation** is normally an extension of organisational growth. Put differently, the growing business is continually compelled to apply specialisation or the division of labour. This is illustrated in the Walt Disney Company case study on page 250.

Job specialisation provides benefits as well as limitations to organisations. Table 8.1 summarises the benefits and limitations of job specialisation.

Although some degree of specialisation is necessary in every organisation, it should not be carried to extremes because of the possible negative consequences. Managers should be sensitive to situations in which extreme specialisation should be avoided.

To counter the limitations or problems associated with specialisation, managers have sought other approaches to job design that achieve a better balance between organisational demands for productivity, efficiency and effectiveness on the one hand, and individual needs for creativity and autonomy on the other. Job rotation, job enlargement, job enrichment and work teams are amongst these alternative approaches.

Job rotation involves systematically moving employees from one job to another. For example, a worker in a warehouse might unload trucks on Monday, carry incoming inventory on Tuesday, verify invoices on Wednesday, pull outgoing inventory from storage on Thursday and load trucks on Friday. The jobs do not change, but instead, workers move from job to job. For this very reason, job rotation has not been very successful in enhancing employee motivation or satisfaction. Jobs that are amenable to rotation tend to be relatively standard and routine. Job rotation is most often used today as a training device to improve worker skills and flexibility.

Job enlargement was developed to increase the total number of tasks that a worker performs. As a result, all workers perform a variety of tasks. It was assumed that this would reduce the level of job dissatisfaction. Unfortunately, although job enlargement

does have some positive consequences, these advantages are often offset by the disadvantages. For example, training costs may be higher, unions may argue that pay should increase because the worker is completing more tasks, and, in many cases, work remains boring and routine even after job enlargement has taken place.

Job enrichment is a more comprehensive approach than job rotation and job enlargement. It involves increasing both the number of tasks the worker does and the control the worker has over the job. To implement job enrichment, managers remove some controls from the job, delegate more authority to employees and structure the work in complete units. Job enrichment may also involve continually assigning new and challenging tasks, thereby increasing employees' opportunities for growth and advancement.

Another alternative to job specialisation is work teams. Work teams allow an entire group to design the work system it will use to perform an interrelated set of tasks. For example, a work team may assign specific tasks to team members, monitor and control its own performance, and have autonomy over work scheduling.

CASE STUDY: The Walt Disney Company

The Walt Disney Company is known worldwide for bringing decades of fun and fantasy to families in the form of animated and live-action motion pictures, amusement parks and television series. The company was founded as an animation studio on 16 October 1923, the day that Walt Disney signed a contract with M.J. Winkler to produce a series of Alice comedies. In those early days, the entrepreneur Walt Disney did all the development work himself. He wrote cartoons, drew the pictures himself and then marketed his movies to theatres. As this business grew, he hired additional animators as well as other employees to perform many of these duties. As the company continued to grow, so, too, did specialisation, or the degree to which the overall tasks of the company were broken down into smaller and more specialised tasks. Today, Disney is the largest diversified international family entertainment and media enterprise.

The Walt Disney Company operates through four primary business units, which it calls business segments:

1. Studio Entertainment, which includes the company's film and music recording label and theatrical divisions;
2. Parks and Resorts, featuring the company's theme parks, cruise line and other travel-related assets;
3. Media Networks, which includes the company's television properties; and
4. Consumer Products and Interactive Media, which produces toys, clothing and other merchandising based upon Disney-owned properties, and includes Disney's Internet, mobile, social media, virtual worlds and computer games operations.

The company employed approximately 199 000 people as of September 2017.

Sources: Compiled from information in The Walt Disney Company. *Fiscal Year 2017 Annual Financial Report*. Available at https://www.thewaltdisneycompany.com/wp-content/uploads/2017-Annual-Report.pdf [Accessed 18 November 2018]; Walt Disney Studios. History. Available at https://studioservices.go.com/disneystudios/history.html [Accessed 13 May 2019].

Table 8.1: Specialisation in the workplace

Benefits of specialisation	Limitations of specialisation
Workers that perform specialised tasks become experts in performing each task that they have responsibility for.	Workers who perform highly specialised tasks may bec and feel they need more challenging tasks to perform. T absenteeism, low morale, conflict, and a lower quality o

If workers perform several different tasks, some time is lost as they stop doing a particular task and move to the next one. Specialisation may lead to a decrease in the transfer time between tasks.	In some cases, it may happen that the time spent on mo progress from worker to worker is greater than the time same worker to change from one job to the next. In suc benefits of specialisation are not realised.
The more specialised a job is, the easier it is to develop specialised equipment to assist with that job.	Specialised equipment is more expensive, and the train proficient in using this equipment can also be very high.
When an employee who performs a highly specialised job is absent or resigns, the manager is able to train somebody new at relatively low cost.	Specialised workers can be hard to replace, and the rep can also be relatively high.

8.3.2 Grouping jobs: Departmentalisation

A second principle or building block of organisational structure is the formation of departments. While this is a result of specialisation, it also promotes specialisation since it is necessitated by the logical grouping of activities that belong together. The reasons for **departmentalisation** are therefore inherent in the advantages of specialisation, and the pressure in a growing business to split the total task of management into smaller units. As soon as a business has reached a given size, it becomes impossible for the owner–manager to supervise all the employees, so it becomes necessary to create new managerial positions according to departments based on a logical grouping, in manageable sizes, of the activities that belong together.

The various departments created constitute the organisational structure of the business as they appear on the organisation chart. Depending on such factors as the size and kind of business, and the nature of its activities, various organisational structures may be developed through departmentalisation.

Some common bases for departmentalisation include the following:

- Functional departmentalisation;
- Product departmentalisation;
- Location departmentalisation;
- Customer departmentalisation; and
- The matrix organisational structure.

8.3.2.1 Functional departmentalisation

Functional departmentalisation, as shown in Figure 8.1, is the most basic type of departmentalisation. Here, activities belonging to each management function are grouped together. Activities such as advertising, market research and sales, for example, belong together under the marketing function, while activities concerned with the production of goods are grouped under operations.

8.3.2.2 Product departmentalisation

Product departmentalisation is illustrated in Figure 8.2. Departments are designed so that all activities concerned with the manufacturing of a product or group of products are grouped together in product sections, where all the specialists associated with the particular products are grouped. Edcon applied product departmentalisation by grouping all of its activities and resources into three divisions. Edcon’s human resources, financing and marketing needs for the various divisions will differ. For example, the human resources, marketing and financing needs for the Edgars division will differ from those needs in the Jet division. This is a logical structure for large businesses providing a wide range of products or services. The advantages of this structure are that the specialised knowledge of employees is used to maximum effect,

decisions can be made quickly within a section, and the performance of each group can be measured easily.

The disadvantages are that the managers in each section concentrate their attention almost exclusively on their products and tend to lose sight of the products of the rest of the business. Moreover, administrative costs increase because each section has to have its own functional specialists such as market researchers and financial experts.

8.3.2.3 Location departmentalisation

Location departmentalisation is illustrated in Figure 8.3. This is a logical structure for a business that manufactures and sells its products in different geographical regions – for example, Woolworths Holdings Limited, which operates and markets its range of products all over sub-Saharan Africa, Australia and New Zealand.[2] This structure gives autonomy to area managements, which is necessary to facilitate decentralised decisionmaking and adjustment to local business environments. This structure is also suitable for a multinational business.

Figure 8.1: Functional departmentalisation

Figure 8.2: Product departmentalisation

Figure 8.3: Location departmentalisation

8.3.2.4 Customer departmentalisation

Customer departmentalisation is adopted particularly where a business concentrates on some special segment of the market or group of consumers or, in the case of industrial products, where it sells its wares to a limited group of users. Figure 8.4 illustrates this structure. The structure has the same advantages and disadvantages as departmentalisation according to product and location or geographical area. A bank, for example, can have various departments servicing private and corporate clients.

Unlike a functional structure in which activities are grouped according to knowledge, skills, experience or training, a section based on product, location or customers resembles, in some respects, a small, privately owned business. It is more or less autonomous and is accountable for its profits or losses. However, unlike an independent small business, it is still subject to the goals and strategies set by top management for the business as a whole.

Figure 8.4: Customer departmentalisation

8.3.2.5 Matrix organisational structure

The **matrix organisational structure** is important because no organisational structure, whether designed according to function, product, location or customer, will necessarily meet all the organisational needs of a particular business. Where departments are formed according to function, there is sophisticated specialisation, but co-ordination remains a problem. If they are formed according to product, location or customer, certain products or regions may be successful, but the rest of the business will not reap the benefits of good organisation. To overcome these problems, which mainly occur in large businesses and in businesses handling specific projects, the matrix organisational structure has been created to incorporate the advantages of both structures discussed earlier. As indicated in Figure 8.5, horizontal (staff) and vertical (line) authority lines occur in the same structure so that project managers (horizontal) and functional managers (vertical) both have authority.

Figure 8.5: The matrix organisational structure

This organisational structure is particularly suited to ad hoc and complex projects requiring specialised skills. For example, IBM created a matrix structure for the development of its personal computer and disbanded the team when the product had been launched successfully. However, in other businesses, the matrix structure may be permanent. An example is a car manufacturer that continually develops certain models as projects. The major advantage of the matrix structure is that specialist project managers can help manage complex projects while the advantages of functional specialisation are retained. The disadvantage is divided authority. Both project leader and departmental head can exercise authority over the same employees. The unity of command is therefore affected, and there is a serious risk of soured relations between the project and functional executives. In addition, the position of employees may be difficult since they have to satisfy two bosses.

8.3.3 Establishing reporting relationships

The third basic principle or building block of organisational structure is the establishment of reporting relationships among positions. An organisation like Edcon needs to be able to answer questions such as: Will the marketing manager of Edcon's Jet division report to the operations manager, or will the operations manager report to the marketing manager? Or should both report to the general manager? Furthermore, who should report to Edcon's chief executive officer?

The first step in establishing **reporting lines** is to determine who reports to whom. Clear and precise reporting lines are important so that everybody knows who is in charge of which activities. This is called the **chain of command**. The chain of command can formally be defined as a clear and distinct line of authority among the positions in an organisation. The chain of command has two components: the unity of command and the scalar principle. Unity of command suggests that each person within an organisation must have a clear reporting relationship to one, and only one, supervisor. The scalar principle suggests that there must be a clear and unbroken line of authority that extends from the lowest to the highest position in the organisation. The popular saying 'the buck stops here' is derived from this idea. Someone in the organisation must ultimately be accountable for every decision.

The second step in establishing reporting lines is to determine how many people will report to one manager, known as the **span of management** (also called the span of control). Figure 8.6 illustrates this concept schematically.

For years, managers and researchers sought to determine the optimal span of management. For example, should it be narrow (with few employees per manager) or wide (with many employees per manager)? A narrow span of management will result in a relatively tall organisational structure, which may mean that managers are being underutilised and that there is excessive control over employees. A wide span of management will result in a flat organisational structure, in which it may be difficult to co-ordinate and control the tasks of a large number of employees. In order to find the ideal or most appropriate span of management for an organisation, various factors should be taken into account.

In some organisations, additional factors may influence the optimal span of management. The relative importance of each factor also varies in different organisational settings. Hence, managers need to assess the relative weight of each appropriate factor or set of factors when deciding on the optimal span of management (also referred to as the 'span of control') for their unique situation.

Figure 8.6: The span of management

The span of management

The following factors influence the appropriate span of management:

- The skills, competence and maturity of the supervisor and the employee reporting to them (the greater the skills, competence and maturity are, the wider the potential span of management is);
- The physical dispersion of employees (the greater the dispersion is, the narrower the potential span of management is);
- The complexity of the business (the more complex the business is, the narrower the potential span of management is);
- The extent of non-supervisory work in a manager's job (the more non-supervisory work there is, the narrower the potential span of management is);
- The degree of required interaction between supervisor and the employee reporting to them (the less interaction that is required, the wider the potential span of management is);
- The extent of standardised procedures (the more standardised the procedures are, the wider the potential span of management is);
- The similarity of tasks being supervised (the more similar the tasks being supervised are, the wider the potential span of management is);
- The frequency of new problems (the more frequently new problems arise, the narrower the potential span of management is); and
- The preferences of supervisors and employees reporting to them.

Source: Adapted from Griffin, R.W. 2013. *Management principles and practices*. Eleventh edition. USA: South-Western Cengage Learning, p. 352.

8.3.4 Establishing authority relationships

The fourth building block in structuring organisations is the determination of how authority is to be distributed among positions. The previous section discussed the process of task distribution. Here, the broad functions of the business are broken up into smaller specialised units that are allocated to certain departments and persons. However, this is not the end point of organising. The assignment of tasks to sections and members of staff also entails the assignment of responsibility, authority and accountability to each post in an organisational structure. This further entails the creation of organisational relations – that is, stipulating the persons from whom employees receive instructions, to whom they report, and to whom and for what they are responsible.

Responsibility can be defined as the duty to perform the task or activity as assigned. **Authority**, on the other hand, is the right to command or to give orders. Authority is power that has been legitimised by the organisation. It includes the right to take action to compel the performance of duties and to discipline default or negligence. In the formal business structure, several examples of which have been discussed, the owners of the business possess the formal authority. They appoint directors and give them authority. These directors in turn appoint managers, who assign a certain authority to employees who report to them. In this way, authority flows down the line.

Formal authority is distinguished by three characteristics:

- Formal authority is vested in organisational positions, not in people. Managers have formal authority based on their position in the formal organisational hierarchy. Other people in the same position have the same authority.
- Formal authority is accepted by employees. Employees comply in an organisation because they believe that managers have a legitimate right to issue orders.
- Formal authority flows down the vertical hierarchy of an organisation. Positions at the top of the organisational hierarchy are vested with more formal authority than positions at the bottom.

An important distinction in many organisations is between line authority and staff authority, reflecting whether managers work in line or staff departments in the organisational structure.

8.3.4.1 Line authority

Line authority is authority delegated down through the line of command. In Figure 8.7, the managing director has line authority over the financial, human resource and marketing managers, while the marketing manager has line authority over the advertising manager, and so on, down the line of command. The managers in this line are directly responsible for achieving the goals of the organisation.

8.3.4.2 Staff authority

Staff authority is an indirect and supplementary authority. Individuals or sections with staff authority – for example, the legal adviser and the market-research section shown in Figure 8.7 – assist, advise and recommend. Their source of authority is usually their special knowledge of a particular field.

Accountability is the mechanism through which authority and responsibility are brought into alignment. Accountability means that the people with authority and responsibility are subject to reporting and justifying task outcomes to those above them in the chain of command.

For an organisation to function well, every employee needs to know what he or she is accountable for, and accept the responsibility and authority for performing those tasks.

Another important concept related to authority relationships is delegation. **Delegation** is the process that managers use to transfer authority and responsibility to positions below them in the organisational hierarchy. It is important to note that managers can delegate authority and responsibility, but they will always stay accountable for the task outcomes.

Just as authority and responsibility can be delegated from one individual to another, organisations also develop patterns of authority across a wide variety of positions and departments. **Decentralisation** is the process of systematically delegating power and authority throughout the organisation to middle- and lower-level managers. It is important to note that decentralisation is actually one end of a continuum anchored at the other end by **centralisation**, the process of systematically retaining power and authority in the hands of higher-level managers. Thus, in a decentralised organisation, decision-making power and authority are delegated as far down in the chain of command as possible. In a centralised organisation, decision-making power and authority are retained at the higher levels of management.

Once authority relationships have been completed, management has to design an organisational structure that will enable the various jobs to be done in a co-ordinated fashion.

Figure 8.7: Line and staff authority in the organisational structure

8.3.5 Co-ordinating activities

The fifth and last building block in structuring an organisation is co-ordination.

Organisation means dividing up the total task of the business into smaller units to take advantage of specialisation and achieve the goals of the business as productively as possible. However, this division of work into smaller jobs immediately raises the problem of co-operation, or the co-ordination of divided tasks and various departments into an integrated whole to achieve the goals of the business.

The key to keeping each department focused on the organisation's goals is co-ordination or the process of linking the activities of the various departments in the organisation into a single integrated unit. The primary reason for co-ordination is that departments and groups are interdependent. They depend on each other for resources in order to be able to perform their activities. The greater the interdependence between the departments, the more co-ordination the organisation acquires.

In the case of Edcon, the various sections in the Edgars division are interdependent. Furthermore, all three divisions of Edcon are interdependent. The combined performance of the three divisions will determine the overall performance of Edgars Consolidated Stores Ltd.

Without co-ordination, individuals and departments lose sight of the organisation's primary goals and of their part in that effort. Co-ordination is the synthesis of separate parts into a unity and, as such, it is the binding factor in the managerial process. It means the integration of goals and tasks at all levels, and also the integration of all departments and functions to enable the business to work as a whole. In addition, an element of timing is necessary because various smaller tasks have to be scheduled to mesh with each other.

Hence, co-ordination is an endeavour by management to develop congruence, or harmony of goals, through organising. Other mechanisms that promote co-ordination are the organisation chart, the budget, a committee, the broad policy and procedures in accordance with which tasks are carried out, and the information system of the business.

Once management has deployed all the building blocks of the organisation, it can finalise the formal structure of the organisation. Besides the formal organisation of a business, there is also an informal organisation that often supplements it and helps it to run smoothly.

8.4 The informal organisation

So far, only the formal organisation has been considered. However, relations within a particular business are not confined to those prescribed by the formal organisation chart. Alongside the formal structure there is also an informal organisation, which may be defined as the interpersonal relations between people in a business that are not defined by the formal organisational structure.

Because there is regular interaction between people, social relations are established that assume a definite form. This interaction is achieved by informal communication, also known as 'the grapevine'. Moreover, these relations exist not only between individuals, but also between groups, though on an informal basis. If these relations are sound, they can support the formal structure, but if not, they may include activities that are not in harmony with those activities envisaged in the formal structure. Rather than trying to suppress the informal structure, management should encourage it, for the following reasons:

- Informal communication takes place much more rapidly than formal communication, and therefore decision-making could be expedited.
- The informal organisation promotes teamwork within departments, as well as co-operation between departments.
- The informal organisation supports the formal organisation.

Having considered the basis of the task of organising, we will now examine some of the factors that may influence the organisational structure.

8.5 Factors that influence organisational structure

Organising can only be carried out effectively if the organisational structure has been developed to optimise the execution of strategies and plans. In other words, plans can only be implemented successfully if the organisational structure makes this possible. Planning, leading and control are facilitated if management has an effective and dynamic organisational structure. This raises the question: Which organisational structure is the best? There is no definite answer. Each business must choose a structure that is best suited to its particular activities or may be adapted to its strategy and requirements.

Organising is carried out in a context where many different factors need to be taken into account. Each of these factors may provide input in the designing of the organisational structure.

Some experts believe that the environment in which a business operates is a decisive factor. Others emphasise the connection between strategy and structure. Obviously, the size and complexity of the business, the competence of its employees,

and the nature of the product and the market all play important parts. Moreover, the organisational climate or corporate culture should not be ignored in designing the structure, and in forming departments and distributing tasks. Above all, according to modern management theory, whichever structure is designed should be adaptable to changes in the business environment. These factors will now be examined briefly.

8.5.1 The environment in which a business operates

The environment in which a business operates was discussed in detail in Chapter 4. The management environment may be taken as a basis for designing an organisational structure, since it is the starting point for the development of strategy, on the one hand, and because the organisational structure is the mechanism that should keep the business in touch with its environment, on the other. A business has to adapt to its environment to survive. There are various types of environment.

8.5.1.1 Stable environment

A stable environment is one that does not change much or is not subject to unexpected change. Here, product changes are the exception rather than the rule and, when a change does occur, plans can be made to cope with it in good time. Demand for the product is regular, with only slight fluctuations. New technological changes are small or unlikely. A foundry manufacturing manhole covers and a workshop making violins both operate in stable environments. In a stable environment, the functional structure is suitable because there is little in the way of innovation, and no great need for co-ordination and co-operation between departments. Similarly, businesses with fewer competing markets, which are under less pressure regarding product development to satisfy consumers' needs (for example, a manufacturer of nuts and bolts), will have a functional structure with few specialists such as market researchers and advertising experts. Decisionmaking takes place mainly at the top level.

8.5.1.2 Turbulent environment

A turbulent environment is one in which changes are the norm rather than the exception: competitors unexpectedly bring out new products and technological innovations cause revolutionary changes in the manufacturing process or the product itself. The pharmaceutical industry is an example of such an environment, which necessitates many specialists for market research, product development and production, and close co-ordination and communication between them. In such a business, departmentalisation according to product is especially suitable, as this speeds up decision-making. More decisions are made in the separate departments than by top management. The retail environment in which Edcon operates is a challenging environment. In the opening case we saw that changes, particularly in the economic environment, lead to changes in terms of the strategy of the company. Changes in strategy lead to changes in the structure of the company, which will be addressed in Section 8.5.2.

8.5.1.3 Technologically dominated environment

Technology and technological advancements have an influence on all organisations in all types of industries. Technology changes the speed and manner in which organisations conduct and transact business, creating a digital age. The organisational design for a technologically dominated environment (when a particular technology forms the basis for a business's product) will be influenced even more by the level of technological sophistication. Technologically complex firms tend to have more managers and more levels of management because specialised technicians work in

small groups with a narrow span. Technology, and especially technological innovation, requires an adaptable organisational structure that is based on one or other form of departmentalisation. Apple Inc. serves here as an example. Apple's structure supports the company's strategies aimed for further technological innovation. It maintains a traditional hierarchy, with some key elements from other types of organisational structures.[3]

8.5.2 The relationship between strategy and structure

The close relationship between the strategy of a business and its organisational structure is well known. The implication is that the strategy provides a direct input into the design of the organisational structure and that the structure cannot be separated from the strategy. Structure should always follow strategy.

8.5.3 The size of the business

It is equally obvious that the structure also depends on the number of employees and managers to be co-ordinated. An increase in the size of the business also creates a need for greater specialisation, more departments and more levels of management. The danger of bureaucratic management as a result of detailed procedures, strict job demarcation and, consequently, less emphasis on initiative and regeneration is always present in large businesses.

8.5.4 Staff employed by the business

There is also a close relationship between an organisational structure and the competence and role of staff, whether this competence is a result of training or experience, availability or attitude. Edcon has established the Edcon Retail Academy, which provides training related to merchandising and operations to employees. In this way, Edcon improves the competence of its staff. In management, especially in top management, the structure influences both the choice of strategy, and the preferences about how things should be done. Most managers have a personal preference for a particular organisational structure, for the type of relations with employees, and also attitudes to formality and authority. As to the latter two, some experts maintain that the tendency is to move away from the strictly formal bureaucratic structure.

8.5.5 The organisational culture

The final factor that plays an important part in organisational design is organisational culture. This so-called culture is a concept that may be defined as the beliefs and values shared by people in a business. It is the 'personality' of the business. Unless management analyses this concept correctly, it will never know why employees do, or do not do, certain things. Corporate culture comprises basic values that are reflected not only in organisational behavioural patterns, but also in aspects such as the business's architecture, office decor, dress regulations and the general way in which things are done. Edcon's culture is one of inclusiveness, built on the organisation's values of people, integrity, performance and professionalism.

The type of structure that leads to the successful implementation of tasks also depends on the culture of the business. The structure of a business with a formal culture will differ from one with a more informal culture.

These factors are some of the considerations that may influence the design of an organisational structure. They are, however, no more than guidelines for organising. It should be understood that the organising process is not only used for a new structure.

Any existing organisational structure should be revised whenever the organisation's strategy or plans are changed.

8.6Summary

The setting in motion of the planned activities is part of the organising task of management. Organising is the development of a structure or framework within which the tasks to be performed for the accomplishment of goals and the resources necessary for this are allocated to particular individuals and departments. This division of labour may be done in various ways, and must ultimately be co-ordinated to make concerted action possible. Someone, however, has to take the lead in setting in motion the activities involved in the various phases of planning, organising and control. The third fundamental element of management will be dealt with in Chapter 9.

Small business perspective

Entrepreneurial businesses can be classified as either informal, micro, very small, small, medium or large organisations. In the National Small Business Amendment Act of South Africa (No. 26 of 2003), a micro business is defined as a business with five or fewer employees. A very small business employs between one and ten employees, and a small business between 11 and 50 employees. Medium and large businesses employ more than 50 employees.

In this chapter, the importance of organising as an integral and indispensable component of the management process was articulated. Organising is important for every business, regardless of its size. However, entrepreneurs who start their own businesses, usually on a smaller scale, will not need formal organisational structures and lines of authority and reporting in the start-up phase of their businesses. During this phase, the entrepreneur normally fulfils many (if not all) of the managerial and operational activities him- or herself. The main aim of the entrepreneur during this phase is to grow the business and to establish a customer base. Organisational growth can be viewed from various perspectives.

First, the small business will grow financially. It will realise increases in turnover (sales), profit, assets and return on its investments. Second, the small business will grow in terms of its maturity – it will implement new processes and procedures, which will lead to an increase in its effectiveness and efficiency. Third, the small business will grow strategically. The small business will reassess the environment with the aim of identifying strengths, weaknesses, opportunities and threats. Last, the small business will make structural changes that fit the changes to its strategy. As the micro or small business starts to grow, the business will need more staff. With more staff comes the need for a more formal organisational structure. It is at this point that the entrepreneur will start delegating many of the managerial and operational tasks and activities to other people. The role of the entrepreneur then starts to move from being an innovator and creator of new business ideas, to a small business manager who is risk-, change- and innovation-averse.

There are dangers at this point of the business's development. Even though the entrepreneur may have excellent skills to identify new business ideas and opportunities, he or she may not have the necessary managerial skills to manage the growing business effectively. To be successful, the small business manager must be able to:

•perform the management tasks of planning, organising, leading and control;

•organise the growing business in a meaningful manner, applying all the principles of organising as explained in this chapter;

•ensure co-operation and co-ordination between the various departments and individuals in the business;

•ensure the effectiveness of groups and teams working in the business;

•facilitate formal communication in the business;

- compile and implement the necessary rules, policies and procedures to ensure that goals are achieved; and
- manage all programmes and projects towards goals accomplishment.

KEY TERMS	
authority	job specialisation
chain of command	location departmentalisation
co-ordination	matrix organisational structure
customer departmentalisation	organisation and culture
departmentalisation	organising
functional departmentalisation	product departmentalisation
job design	reporting lines
job enlargement	responsibility
job enrichment	span of management
job rotation	work specialisation

Questions for discussion

Reread the case study on page 247 and answer the following questions:

1. Do you agree that departmentalisation according to product is the most suitable organisational structure for Edcon? Substantiate your answer.
2. Identify the various authority relations that could exist in the Edcon group.
3. Do you think that a narrow or high organisational structure would be appropriate for Edcon? Substantiate your answer.
4. Identify factors that could influence the organisational design of Edcon.

Multiple-choice questions

1. Mrs Mabula, the operations manager of a large organisation, decides to remove some controls from the jobs that the employees who report to her perform, to delegate more authority to these employees, and to structure the work in complete work units. Mrs Mabula is implementing _________.
   a. work teams
   b. job enlargement
   c. job enrichment
   d. job rotation

2.In _________, horizontal and vertical authority lines occur in the same organisational structure so that project managers and functional managers both have authority.

a.product departmentalisation
b.customer departmentalisation
c.a matrix organisational structure
d.location departmentalisation

3.Which of the following is not one of the fundamentals of organising that managers can use in constructing an organisation?

a.Designing jobs
b.Grouping jobs (departmentalisation)
c.Choosing a location
d.Co-ordinating activities.

4.The statement 'product changes are the exception rather than the rule and, when a change does occur, plans can be made to cope with it in good time' is associated with a __________ environment?

a.turbulent
b.technologically dominated
c.stable
d.politically unstable

5.A small business is defined as having _________ employees.

a.five or fewer employees
b.between 11 and 50 employees
c.between 1 and 10 employees
d.more than 50 employees

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CHAPTER 9

Leading

Mari Vrba

The purpose of this chapter

The preceding two chapters examined the management functions of planning and organising. While planning and organising set the wheels of the management process in motion, the process is by no means complete, since the plans must be implemented. It is here that the leading function of managers becomes crucial. This chapter deals with the difference between leadership and management, the components of the leading function and leadership theories. Employee motivation, effective communication and team leadership relate to leadership effectiveness and the chapter concludes with a brief discussion of these concepts.

Learning outcomes

On completion of this chapter you should be able to:

- define the term 'leadership'
- differentiate between leadership and management
- describe the components of leadership
- discuss the major leadership theories
- identify contemporary leadership issues
- explain why managers should understand what motivates their employees' behaviour
- differentiate between groups and teams in organisations
- describe a simple communication model.

9.1 Introduction

If organisations were comprised solely of machines that could implement plans predictably and with precision, only the planning, organising and control functions of management would be necessary to achieve an organisation's goals. However, organisations employ people to activate the financial, physical and informational resources of the organisation. Managers perform the function of leading by influencing, guiding and directing the organisation's employees towards achieving the goals of the organisation. In this chapter, we examine the nature of the leading function of managers.

9.2 The nature of leadership

Leadership is one of the most researched and most controversial topics in management. Many researchers have attempted to define leadership, using variables such as traits, behaviour, influence, interaction patterns and role relationships, but it remains an elusive concept.

Sifting through the many definitions for leadership, two aspects of leadership emerge. First, leadership involves *influence*, and second, it has to do with the influence *one person exerts over another person or persons*. Other aspects of leadership in an organisational context are that it should be *intentional* with the purpose of achieving *specific outcomes*, and that employees should be *willing* to follow a leader.[1] A

further crucial aspect of leadership is the *interdependent relationship* between a *leader* and his or her *followers*. Without followers, leaders cannot lead. Employees do not blindly follow their leaders, even if they are in leadership positions; they must accept them as leaders to willingly follow them.[2] Thus, we can define leadership from an organisational point of view as the process of influencing employees to work willingly towards the achievement of organisational objectives.

In the **leading** function, managers take the lead to bridge the gap between formulating plans and reaching goals. They transform plans into reality by influencing individuals, groups and teams in the organisation through communicating with them and by creating an environment conducive to motivating employees.

9.2.1 Leadership and management

Leadership is different from management. Management is broader in scope, comprising four management functions, of which leading is one. People can work as managers without being true leaders because they do not have the ability to influence others. Conversely, there are leaders in organisations who are not managers. For example, the informal leader of a group may have more influence in the group than the manager because of his or her ability to influence group members.

Influencing[3] is the process leaders follow when communicating ideas, gaining acceptance of them, and inspiring followers to support and implement the ideas through change. Influencing is also about the relationship between leaders and followers. Managers may coerce employees to influence their behaviour, but leaders do not.

In the challenging global business environment of the 21st century, organisations need managers who are also strong leaders. Figure 9.1 illustrates the process of developing managers into leaders.

Figure 9.1: The integration of leadership and management

While leadership is not the only component of organisational success, it is an important contributing variable. Indeed, in the South African business context, there are many examples of exceptional business leaders of successful organisations. One example is the Group Chief Executive Officer (CEO) of Discovery, Adrian Gore, who founded and built Discovery into one of South Africa's most successful organisations. Mr Gore has received many awards for his contributions to South African business and society, as described in the case study that follows.

CASE STUDY: Discovery Limited

Adrian Gore, Group Chief Executive Officer of Discovery, is known for his stance on positive leadership. In November 2018, he made a speech which was widely quoted in the media because it was so different in content from the bad news South Africans are subjected to on a daily basis. It was a plea for a better, fairer nation, based on the exactness of science. The occasion was the 2018 Discovery Leadership Summit, a global thought leadership event with the aim to provide a platform for some of the world's most brilliant thinkers to share their leadership strategies and insights on issues relating to business, economics, government and science.[4] Mr Gore also penned an article in the *Business Day* newspaper on the same topic.

In short, he made the case for positive leadership in South Africa on all levels. He wrote, 'I'm known for repeatedly making the call for positive leadership, to liberate our country's

incredible potential. What fascinates me is the criticism I receive for my naivety given the challenges we face. I'm not discounting the fact that we are faced with real challenges, we do: GDP growth is at -0,7 per cent; half of those aged between 15 and 35 years old are jobless; we have a bloated public-sector wage bill and a hefty budget deficit to fill; and tragic inequality. My plea for positivity is not despite these challenges, but because of them – and it is rooted in cold hard facts'.[5]

The 'optimum paradox,' which is the gap between private hope and public despair, forms the basis of his ideas. He cited the work of Nobel prize-winning behaviour economist Angus Deaton as evidence for the fact that people believe, in their personal lives, that their future will be better than their past (the optimism bias). In contrast, they believe that the world (and the country) is on an irreversible downhill course (declinism). Mr Gore argued that the major flaw in declinism is the failure to distinguish between absolute and relative changes and to misinterpret relative decline as absolute decline.

It is a fact that South Africa, like the world at large, is essentially a better place as time progresses. Mr Gore quoted factual evidence to prove this, including the following: South Africa's GDP is 2,5 times the size it was in 1994 on a dollar basis; formal housing increased by 131 per cent (from 1996 to 2016); new HIV infections went down by 60 per cent from 1999 to 2016; and the murder rate per 100 was down 50 per cent from 1994 to 2017. The South African economy is substantial: in terms of stocks traded in 2017, the country trumps the Middle East, the Eastern and Northern African regions, Singapore and Norway. The country holds 82 per cent of the pension fund assets in Africa, 18 times that of Nigeria. South Africa's market enables the building of huge companies, for example Discovery's revenue footprint is more than half of that of Mauritius and both Standard Bank and First Rand are bigger than all Nigeria's banks combined on a tier one capital basis. The economy is also relatively stable and not too risky to invest in. The GDP growth is the lowest in volatility when compared to other BRICS countries (from 1994 to 2017), suggesting that we misplace risk and thus miss opportunities. He described the country as a place of opportunity and a huge market, which is why Discovery has grown into a global business.

According to Mr Gore, South Africans see problems as unsolvable and believe that the decline of the country is unavoidable. They do not acknowledge the positive aspects in the country because they are obsessed with the problems of the day. Before 2005 it was HIV and AIDS; in the early 2000's it was serious crime, followed by xenophobia in 2008 and the Eskom power crisis; from 2016 we concentrated on #FeesMustFall, state capture and land expropriation. These problems are not inflexible, because they change over time. Although the problems are serious and tragic, South Africans have the ability to manage them. The country has remarkable potential, but it needs to deliver economic growth to solve its problems.

Thus, in Mr Gore's view, South Africans have a choice: a problem-centric leadership approach, by perpetrating declinism, or a vison-based leadership approach, which is the solution to declinism. A vision-based leadership approach involves recognising the country's progress and creating hope. South Africans need to see the country's problems as real, but solvable, and they should seek the positive signals next to the negative ones in the environment. Furthermore, they need to acknowledge the potential of the South African economy and invest in it – this is how change happens.

Mr Gore behaves in the way in which he encourages others to behave. Discovery has been investing in South Africa since 1992, when as a young actuary working at Liberty, he perceived the health-care market as unsustainable, and in this he saw an opportunity. 'When my colleagues and I started out, we knew that the case for disruption was strong. Insurance models at the time did little to recognise the behavioural nature of risk, let alone actively promote and incentivise better health. Life insurance systems were based on the idea that risk is static, with underwriting taking place once, at policy inception. It made no sense as an approach. In fact, it was predicated on death, and not – ironically – on life. That's how the Vitality business model was born. We knew we could harness the behavioural biases and heuristics that typically conspired against health improvement to help nudge people in the right direction – making healthier choices the easier choices. We also knew if our core

purpose was to make people healthier, and enhance and protect their lives – the same core purpose that governs us today – we could align our commercial interests with making society healthier. That is a profound opportunity.'[6]

Discovery has since overhauled health care in South Africa and changed the insurance landscape in the country. It is rolling out its Vitality Shared-Value Insurance model globally with foreign insurance giants. In March 2019, Discovery will launch its bank, based on the same model; linking behavioural science and technology, and connecting the two megatrends to banking. Discovery's entry into banking is bound to shake up the industry because of its innovative plan to 'democratise the best interest rates to people who are managing their money best.'[7] Mr Gore described it as 'the world's first behavioural bank'.[8] A Discovery Bank client who manages his or her money responsibly and effectively, regardless of how much money the person has, will be charged the lowest interest rates in the market.

Asked about his leadership style, Mr Gore explains, 'Leadership is about vision and driving people to a goal. Framing it, drawing it, illustrating it.'[9] One of the characteristics of a good leader, is the ability to instil hope, inspiration and a sense of possibility among people – and to do so authentically. He attributes the success of Discovery not only to his leadership, but also to an effective team, who have built the organisation over the years. Leadership skills can be learnt as no one leadership style is necessarily right. In his opinion it is important to be authentic to who you are. At the same time, you can identify your weaknesses and work on them. He believes that entrepreneurship is the only solution to the country's unemployment problem, and mentorship provides the most powerful support for entrepreneurs. When entrepreneurs start a business there are aspects that they have never experienced or even considered. Many entrepreneurs think they do not need a board as it is a waste of time, but Mr Gore is convinced that having smart, experienced people help you is a gift that you should accept with gratitude.

Discovery has come a long way, but its CEO thinks that there is a great deal yet to build. He has a vision to implement the Vitality Shared-Value Insurance model beyond its 19 current markets. The process is still in its primary stage and has a long way to go (See case study in Chapter 7 for a discussion of Discovery's vision for 2021.)

Adrian Gore graduated from Wits University in 1986. He is a fellow of the Actuarial Society of South Africa, a fellow of the Faculty of Actuaries (Edinburgh), an associate of the Society of Actuaries (Chicago), and a member of the American Academy of Actuaries. In 1998, he was recognised as South Africa's Best Entrepreneur by Ernst & Young, and in 2004 was chosen as South Africa's leading CEO in the annual Moneyweb CEO's CEO of the Year Awards. In 2008 he received the Investec Award for Considerable Contribution in a Career/Profession, and in 2010, was named the Sunday Times Business Leader of the Year. In 2015 Mr Gore was the recipient of the McKinsey Geneva Forum of Health Award. At the 2016 All Africa Business Leaders Awards (AABLA), in partnership with CNBC Africa, he was honoured as the Business Leader of the Year. On behalf of Discovery he also accepted the Company of the Year award, recognising the group's continuing commitment to excellence and outstanding business values, which have impacted business on the continent. In 2018, he received the Sunday Times Top 100 Companies Lifetime Achiever Award. He chairs the South African chapter of Endeavor – a global non-profit organisation that identifies and assists high-growth entrepreneurs. He sits on the World Economic Forum Global Health Advisory Board, which is committed to improving global healthcare and on the Massachusetts General Hospital Global Health Advisory Board, whose mandate is to enhance care for the world's most vulnerable populations, as well as to educate and prepare the next generation of health leaders and educators.

Sources: Gore, Adrian. 2018. My plea for imagining a better, fairer nation is based on hard, cold science. In *Business Day*, Friday 2 November, p. 9.; Shevel, A. 2018. A worrier with a positive outlook. In *Sunday Times Top 100 Companies, Supplement to Sunday Times*, 11 November, pp. 12-13.; Discovery Leadership Summit 2018. Available at https://www.discoveryleadershipsummit2018.co.za. [Accessed 17 November 2018]; *Business Leadership South Africa: Adrian Gore*. Available at https://www.blsa.org.za/about-us/the-board/adrian-gore. [Accessed 17 November 2018]; Pittman, J. 2014. Adrian Gore: The disruptor.

In *Entrepreneur Magazine*. Available at https://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/adrian-gore-the-disrupter. [Accessed 17 November 2018]; Mashego, P. & Thukwana, N. 2018. Discovery promises brave new bank world. In *Business Times*, *Sunday Times*, 18 November, p. 7.

9.2.2 The components of the leading function

In Chapter 8, we discussed organisational structures and the authority relations they create in organisations. These authority relations relate strongly to the leading function of managers because the leading function gives managers the right to use authority, power, responsibility, delegation and accountability to influence employees to achieve the organisation's goals.

The **components of leadership** entail the following:

- **Authority** denotes the right of a manager to give commands to, and demand actions from employees.
- **Power** is a manager's ability to influence the behaviour of employees.
- **Responsibility** is the obligation to achieve organisational goals by performing required activities. Managers are responsible for the results of their organisations, departments or sections.
- **Delegation** is the process of assigning responsibility and authority for achieving organisational goals. Managers delegate responsibility and authority down the chain of command. Delegation refers to giving employees new tasks. Such a task may become part of a redesigned job or may simply be a once-off task.
- **Accountability** is the evaluation of how well individuals meet their responsibilities. Managers are accountable for all that happens in their sections, departments, business units or organisations. Managers can delegate authority and responsibility, but they can never delegate their accountability.

9.2.2.1 Authority

Managers are responsible for ensuring that employees work together to achieve the organisation's goals. Without authority, managers are unable to manage, initiate or sustain the management process. Authority therefore revolves around obtaining the right to perform certain actions (within specified guidelines) to decide who does what, to demand the completion of tasks and to discipline those who fail to do what the organisation expects of them. In short, this entails the right to demand action from employees and the right to act.

Final authority rests with the owners or shareholders of an organisation, who transfer or delegate authority to the board. The board, in turn, delegates authority to top management, top management delegates it to middle management and so on, to the lowest levels. Managers, in turn, delegate authority to employees to enable them to execute tasks. For example, certain managers have the authority to release purchase orders in the organisation's name, and others have the authority to negotiate and conclude contracts on behalf of the organisation. The organisation confers this formal authority on them.

When organisations confer authority to managers, they have the right to expect action from employees. Members of organisational groups also confer authority on a manager if they accept him or her as their leader. Authority and leadership are therefore closely related – the organisation grants authority to managers to lead individuals and groups in achieving the organisation's goals.

9.2.2.2 Power

Leading and power go hand in hand. Without power, a manager might not be able to influence and lead employees towards achieving organisational goals.

Managers have two types of power: position power and personal power. Top management delegates **position power** down the chain of command. Managers have **personal power** when their followers bestow it on them. The chief executive officer of a company, such as Mr Adrian Gore of Discovery, has both position and personal power.

Figure 9.2: The power continuum

Source: Adapted from Lussier, R.N. & Achua, C.F. 2001. *Leadership: Theory, Application, Skill Development*. First edition. Mason, OH: South-Western Cengage Learning, p. 342. © South-Western, a part of Cengage Learning, Inc.

Figure 9.2 depicts the different sources of power on a continuum from position power to personal power.

- **Coercive power** is the power to enforce compliance through fear, whether psychological, emotional or physical. Modern organisations do not use physical force, but employees' psychological or emotional fear, for example, that the organisation will retrench them or exclude them from a specific group, gives managers a form of power that he or she can use to put pressure on employees to comply.
- **Reward power** is based on the manager's ability to influence employees with something of value to them. It concerns the power to give or withhold rewards. Such rewards include, for example, salary raises, bonuses, praise, recognition and the allocation of interesting assignments. The more rewards a manager controls and the more value employees place on these rewards, the greater the reward power a manager possesses.
- **Legitimate power** is the power an organisation grants to a position. Accordingly, a manager has the right to insist that employees do their work and the right to discipline or dismiss them if they fail to comply.
- **Referent power** refers to a manager's personal power or charisma. Employees obey managers with referent power simply because they like them, respect them and identify with them. In other words, the leader's personal characteristics make him or her attractive to others.
- **Expert power** is the power a manager accrues because of his or her expertise, knowledge and professional ability, particularly over those who need the knowledge or information. The more important the information and the fewer the people who possess it, the greater is the power of the person who commands it.

A manager who commands all five types of power is a strong leader. In organisations, managers are not the only ones to possess power. Employees also have power, for example, when a manager is dependent on an employee for information, expertise, or for social influence or because of the employee's extensive social media network both inside and outside the organisation. Individuals accrue power unrelated to their position in the organisation because they obtain information from their social networks, which they can use to take action. For example, an employee is privy to information intended for top managers only, but it was posted on a WhatsApp group by someone

who (perhaps unethically) saw a confidential memo. This information has a direct bearing on both the employee's and her manager's careers, but the manager is unaware of it. Thus, the employee has the power to share or withhold the information from the manager, or to take action to secure her own position.

Factors determining the strength of an individual's social network include the size of the network (access to information from many sources), the number of contacts between the individual and key decision makers in the organisation, and the variety of contacts in the individual's network (contacts, including people in various departments and positions in the organisation and outside of its boundaries with key contacts, provide access to a wider range of information).

Managers should be aware that their employees also possess power. They should use their own power judiciously to accomplish the organisation's goals.

Effective managers use their power to maintain a healthy balance between their own power and that of employees as Figure 9.3 illustrates.

Figure 9.3: Equilibrium between the power of management and that of employees

9.3 Leadership theories

Researchers have studied, developed and tested a variety of leadership theories to determine the key characteristics and behaviour patterns of a good leader.

9.3.1 Traditional approaches to leadership[10]

The major traditional leadership theories are trait theory, behavioural theory and contingency theory. Although researchers developed these theories many decades ago, they still have relevance because they provided the theoretical framework for further research, and the development of more contemporary approaches to leadership.

9.3.1.1 Trait theory

Early research into leadership involved the identification and analysis of the traits of strong leaders. The assumption of trait theory was that strong leaders have certain basic traits that distinguish them from followers and unsuccessful leaders. Many researchers have tried to list the distinctive characteristics of effective leaders.

The results of these studies have been largely inconclusive because traits vary from one leader to another, and some traits develop only after a leader assumes a leadership position.

9.3.1.2 Behavioural theory

The interest of leadership researchers then turned towards investigating how successful leaders behave. An assumption of **behavioural theory** was that successful leaders behave differently from unsuccessful leaders. Researchers tried to determine what successful leaders do – how they delegate, communicate with, and motivate their employees. The belief was that managers could learn the 'right' behaviour.

Research conducted at the University of Iowa, the Ohio State University, the University of Michigan, and the work of Blake and Mouton support the behavioural approach to leadership.

Researchers at the **University of Iowa** identified three basic leadership styles, namely *autocratic, democratic* and *laissez-faire* leadership styles. The researchers

concluded that the laissez-faire style, whereby leaders leave all decisions to their employees and do not follow up, was ineffective on every performance criterion when compared to the other two styles. The researchers found that the democratic leadership style (the style of a leader who involves employees in decisionmaking, delegates authority, encourages participation in deciding work methods and goals and gives feedback) was the most effective style.

Researchers at the **Ohio State University** also identified two leadership styles: *Initiating* structure is the extent to which a leader defines and structures his or her role, and the roles of employees to attain goals. *Consideration* is the extent to which a leader has job relationships characterised by mutual trust, respect for employees' ideas and regard for their feelings. According to the researchers, effective leaders exhibit both dimensions strongly in their leadership style.

At the **University of Michigan**, researchers distinguished between *production-oriented* leaders, who emphasise the technical or task aspects of a job, and *employee-oriented* leaders, who emphasise interpersonal relations. In these studies, employee-oriented leaders were associated with higher group productivity and higher job satisfaction.

The researchers **Blake and Mouton** developed the **managerial grid**, an instrument that identifies various leadership styles on a two-dimensional grid. They used a questionnaire to measure *concern for people* and *concern for production* on a scale of one to nine. The researchers identified the 'ideal' leadership style as the team-management style, where a manager is strong on both dimensions (9,9).

In general, the behavioural theories had little success in identifying consistent patterns of leadership behaviour and successful performance because results varied over different ranges of circumstances. This led researchers to investigate the effect of the situation on effective leadership styles.

9.3.1.3 Contingency or situational theory

The contingency (or situational) approach to leadership acknowledges that predicting leadership success is more complex than examining the traits and behaviours of successful leaders. Contingency theory attempts to determine the best leadership style for a **given situation**. In the development of contingency theories, researchers considered variables such as how structured the task is, the quality of the relationship between the leader and the employees, the leader's position power, the employees' role clarity and the employees' acceptance of the leader's decisions.

Fred Fiedler's contingency theory of leadership proposes that effective group performance depends on the proper match between a leader's style of interaction with employees, and the degree to which the situation gives control and influence to the leader. Fiedler developed an instrument to measure whether the leader is *task oriented* or *relationship oriented*, and he identified three situational criteria that organisations can manipulate to create a proper situational match with the behaviour orientation of the leader. According to Fiedler, an individual's leadership style is fixed. If, for example, a situation requires a task-oriented leader and the person in the leadership position is relationship oriented, the organisation must either change the situation or move the leader to another situation where his or her leadership style is compatible with the situation.

Robert House developed the **path-goal model**, asserting that it is the leader's responsibility to help employees to achieve their goals. Leaders should provide the necessary direction and support to ensure that employees' goals are in line with the organisation's goals and objectives. House identified four leadership

behaviours: *directive, supportive, participative* and *achievement-oriented behaviour*, which managers can use in different situations. Most of the research evidence supports the logic of this theory: if the leader counteracts the employee's limitations in the work situation, this will probably influence the employee's performance positively.

Paul Hersey and **Ken Blanchard** proposed a **situational leadership model** where the premise is that the *work maturity* of employees determines the best leadership style for a particular situation. The employees' need for achievement, their willingness to accept responsibility, their task-related ability and their experience determine their **work maturity**. The manager uses one of four leadership styles: *telling, selling, participating* or *delegating* to match the employees' maturity level in any given situation.

9.3.2 Contemporary approaches to leadership

In the aftermath of the worldwide financial crisis, where many business leaders stood accused of violating the **trust** of their employees and other stakeholders, it is vital that employees and stakeholders in organisations perceive their business leaders as trustworthy. In recent years, the exposure of large-scale fraud and corruption in both the public and private sectors in South Africa has shocked South Africans. Leaders from both sectors need to work hard to restore the public's trust in them.

Being **trustworthy** is key to leadership success and an essential component of successful working relationships between leaders and followers. A leader that is considered trustworthy enables co-operation, encourages information sharing, and increases openness and mutual acceptance with the people he or she manages. Trust is 'the extent to which an individual is perceived to demonstrate ability, benevolence, and integrity'.[11] Distal trust (trustworthiness of the organisation's senior or strategic leaders) and proximal trust (trustworthiness of a person's immediate manager) are two elements of trustworthiness.

The **five dimensions of trust** are the following:

1. Integrity (a manager's honesty and truthfulness).
2. Competence (a manager's technical and interpersonal knowledge and skills).
3. Consistency (a manager's reliability, predictability and good judgement in handling situations).
4. Loyalty (a manager's willingness to protect another person).
5. Openness (a manager's reliability when it comes to telling the whole truth).[12]

Management literature often refers to leaders as individuals who define organisational reality through the articulation of a vision. However, this view of leadership does not only apply to top managers. Managers at all levels are stronger leaders if they can convey the vision of their organisation, business unit, department, group or team to their employees. Visionary leaders, charismatic leaders, transformational leaders and agile leaders all communicate and share their visions in their organisations.

9.3.2.1 Charismatic leadership

The perception is that a strong positive relationship exists between **charismatic leadership** and the employees' performance and satisfaction. Charismatic leaders often have traits such as self-confidence, vision, the ability to articulate the vision, strong convictions about the vision, unconventional behaviour and environmental sensitivity. Charismatic leadership may be most appropriate when the followers' task has an ideological component, perhaps explaining why charismatic leaders most often appear in politics, religion or unusual business organisations.

9.3.2.2 Visionary leadership

Visionary leadership goes beyond charisma. Visionary leaders can create and articulate a realistic, credible and attractive vision of the future of the organisation; this vision grows out of, and improves on, the present. Such a vision creates enthusiasm and brings energy and commitment to the organisation. Visionary leaders exhibit certain skills: the ability to explain the vision to others, the ability to express the vision through their behaviour, and the ability to extend the vision to different leadership contexts.[13] The case study on Discovery in Chapter 7 describes how the company's vision drives its strategy and performance. In the case study at the beginning of this chapter, Mr Gore explains what he thinks good leadership entails (see case study).[14] He explains that in the broader context of South Africa, leaders across the spectrum, from public to private sectors, have a choice: a problem-centric leadership approach, perpetrating declinism, or a vison-based leadership approach. A vision-based leadership approach involves recognising problems as real, but solvable, and looking for the positive signals (next to the negatives) in the environment.

9.3.2.3 Transactional and transformational leadership[15]

James Burns was the first researcher to distinguish between transactional and transformational leadership behaviour. According to him, **transactional leaders** motivate followers by appealing to their self-interest – for example, corporate leaders exchanging pay and status for the work effort of employees. He contrasts transactional leadership with **transformational leadership**, which he describes as a process in which 'leaders and followers raise one another to higher levels of morality and motivation'.[16] Bass[17] further refined the distinction between transactional and transformational leadership by proposing a theory of **transformational leadership**. He describes transactional leadership as an exchange of rewards for compliance, while he views transformational leadership as the leader's effect on followers in that they feel trust, admiration, loyalty and respect for their leader, and they to do more than what the organisation expects of them.

Transformational leaders display behaviour associated with four transformational styles: *idealised behaviour, inspirational motivation, intellectual stimulation* and *individualised consideration*, and a fifth characteristic, based on the other four leadership styles – *idealised attributes*.[18]

In most organisational contexts, transformational leadership is desirable because it improves employee satisfaction, trust and commitment, and results in motivated employees doing more than is expected of them.[19] Research findings indicate that transformational leadership consistently promotes greater organisational performance.[20] Furthermore, transformational leaders are effective in organisations where major change and transformation are taking place.

Transformational leaders possess the unique qualities suited to lead in the Fourth Industrial Revolution (4IR), characterised by a fusion of technologies, blurring the line between the physical, digital and biological domains. Markers of the 4IR are technology breakthroughs in several fields such as robotics, artificial intelligence (AI), nanotechnology, quantum computing, biotechnology, the Internet of Things, fifth generation wireless technologies (5G), additive manufacturing or 3D printing and fully autonomous vehicles. Because of massive change, organisational design, development and governance have entered a challenging new phase. Strategic transformation and change have become inevitable and demand the introduction of new business models, led by transformational and agile leaders (see Section 9.3.3.6). The development and

promotion of a vision is critical and key to the transformational leader being able to move human talent in a preferred direction.[21]

9.3.2.4 Emotional intelligence (EQ) and leadership and transformational leadership[22]

Salovey and Mayer were the first researchers to use the term 'emotional intelligence' (EQ). They define EQ as 'the ability to monitor one's own and others' feelings and emotions, to discriminate amongst them and to use this information to guide one's thinking and actions'.[23]

Daniel Goleman's conception of EQ has moved beyond the original definition of Salovey and Mayer to include emotional competencies in the workplace. He defines emotional competencies as 'a learned capability based on emotional intelligence resulting in outstanding performance at work'.[24] EQ determines the potential of a person for learning the practical skills that underpin four emotional intelligence clusters. Emotional competence indicates how much of that potential a person realised by learning and mastering skills and translating intelligence to capabilities to do a job.

Goleman's emotional competence inventory (ECI) involves 20 competencies that distinguish individual differences in work performance. The competencies support four clusters of general **EQ skills:** *self-awareness, self-management, social awareness and relationship management*. The results obtained in a wide range of studies, where the researchers used the ECI instrument to assess people at all levels, in a wide range of organisations across diverse industries, indicate that each competence has a significant impact on performance. Commenting on the relationship between leadership and EQ, Goleman said the evidence suggests that emotionally intelligent leadership is key to creating an organisational climate that develops and supports employees and encourages them to give their best.[25]

9.3.3 New approaches to leadership

Interest in leadership theory and practice has intensified during the last decade as leaders face new issues and challenges emerging from the enormous changes taking place in the business environment. We examine the following approaches: ethical leadership, cross-cultural leadership, managing diversity, servant leadership, peer-to-peer leadership, and agile leadership.

9.3.3.1 Ethical leadership

Ethical leadership is a prerequisite for effective leadership and entails the expectation that top managers should maintain high ethical standards for their own conduct, demonstrate ethical behaviour consistently, and hold all members of their organisations to the same high ethical stand. Furthermore, ethical leadership in governments, international institutions and in global and local business organisations will be of crucial importance as the Fourth Industrial Revolution takes hold in the world.

The founder and executive chairman of the World Economic Forum, Klaus Schwab, says the development of new technologies causes a widening gap between progress and society's ability to cope with its consequences. Whether it is an impending shift in the nature of work as technology changes production systems, or the ethical implications of re-engineering and what it means to be human, the changes threaten to engulf us if we do not join forces to understand and direct them. New business models as well as ethical, safety and social issues appear as new technologies emerge. Nevertheless, we have not collectively solved some of the most basic questions on critical issues such as the ownership of personal data, security of social infrastructure and systems, and the

rights and responsibilities of the new leaders of the business environment. 'Leadership in these complex times requires nothing less than a wholesale shift of our mental models, a step change in collaborative engagement, and the ability to collectively envisage the futures that we want to create, and manage ourselves away from the dystopias which technological progress can conjure.'[26]

9.3.3.2 Cross-cultural leadership

Cross-cultural leadership skills are crucial for leaders operating in a global environment where they must deal with people from different cultures in different parts of the world. Leaders should have a strategic awareness and an interest in the socioeconomic and political aspects of the countries where the organisation operates. A prerequisite for cross-cultural leadership is outstanding interpersonal skills, including cross-cultural verbal and nonverbal skills and trustworthiness. Flexibility, an acceptance of uncertainty and frustration, and an awareness of one's own prejudices are essential skills for cross-cultural leadership. Furthermore, cross-cultural leadership necessitates interest in different cultures and a willingness to adjust one's own behaviour to accommodate cultural values and norms other than one's own. Cross-cultural leaders should acquire the skill to keep quiet and listen to others.[27]

9.3.3.3 Managing diversity

In organisations worldwide, and specifically in South Africa, the **workforce** is increasingly **diverse** in terms of demographics. Organisations also form non-traditional relationships with employees, by engaging in flexible working arrangements with, for example, full-time contract workers, independent contractors, part-time workers, home-based teleworkers and disabled workers. To accommodate a flexible workforce, organisations need to develop a variety of career paths and incentive systems. When the workforce is heterogeneous in terms of race, gender and ethnicity, organisations can benefit from a diversity of perspectives and approaches to problem solving but should also be proactive to prevent undue conflict. When diversity is not managed properly, there is the potential for interpersonal conflict and difficult communication. The development of conflict resolution systems are crucial in this regard. The role of leaders is to be role models, and to develop the skills in their organisations for valuing diversity, such as diversity training and listening skills. Another management challenge relating to diversity is that organisational culture should change in terms of values, rituals and assumptions in organisations where the current culture does not support the heterogeneous values of the diverse groups representing the workforce.

9.3.3.4 Servant leadership

While **servant leadership** is a timeless concept, Robert K. Greenleaf[28] coined the phrase in *The Servant as Leader*, an essay first published in 1970. In this essay, Greenleaf explained that the servant leader is servant first, in contrast to the person who is leader first. These two leaders are opposite types on a continuum comprising combinations of the infinite variety of human nature. A servant leader focuses mainly on the growth and well-being of people and the communities to which they belong. Servant leadership differs from traditional leadership, which often involves a leader accruing and using power. In contrast, the servant leader shares power and puts the needs of others first. The servant leader helps people to develop and perform to the best of their ability.

Greenleaf's explanation of the difference between servant leaders and other leaders lies in the care taken by the servant leader to ensure that other people's highest priority needs are addressed. Greenleaf extended his ideas to organisations, recognising that organisations could be servant leaders as well. In his opinion, servant-leader

organisations could change the world. The servant-leadership philosophy and practices can apply in many contexts. A surprising number of high-profile management theorists advocate servant leadership, including Ken Blanchard, Stephen Covey, Peter Senge, M. Scott Peck and Margaret Wheatley.

9.3.3.5 Peer-to-peer leadership[29]

Peer-to-peer leadership is effective in organisations using an interconnected central network. The concepts of the *node* (an individual computer in a network), *node-community* (all the computers in a network), *equipotency*, (all nodes in a node community on equal footing) and *relational dynamics* (the interaction between nodes) frames a new concept, that of peer-to-peer leadership.[30] The work of a manager in an equipotent organisation is to set overall goals, provide direction and ensure that the network functions well, but not to tell the node community what to do. In the node community, leadership roles shift rapidly to fit the needs of a given situation. Information flows freely and those who need it can find it and act on it immediately. Feedback becomes an organic part of the workflow and corrections take place immediately. Peer-to-peer leadership is a new way to provide leadership in organisations by using technology and the interconnectedness of a network, where everyone is a sender and a receiver and a leader and a follower, to attain the goals of the organisation.

9.3.3.6 Agile leadership

Agile leadership is the ability of a leader to be able to lead in a wide range of circumstances especially in new, changing and ambiguous situations. Agile leaders use uncertainty to find opportunity. They tend to be obsessive learners and talented innovators who have the ability (and agility) to operate in any system of thinking, and to see issues from the perspectives of others. It is this ability to think in a number of different ways that gives such leaders their agility.[31]

In an age of rapid change, admitting that you do not have all the answers, is a strength and not a weakness. Agile leaders[32] are willing to learn and they are humble. They gather input from both inside and outside the boundaries of their organisations, and they trust those who know better than they do. Change is constant, and when new information becomes available the agile leader adapts. Rapid technology changes and the appearance of new digital competitors drive agile leaders' adaptability. They are experts at dealing with complexity and are willing to change their minds when presented with new information.

Being a visionary leader in the context of agile leadership means creating a compelling, genuine vision and sharing it extensively in the organisation, creating a common identity and sense of destiny. In times of rapid technology, disruption of business models and new opportunities emerging, a clear vision is critical for the organisation to succeed. Discovery's Mr Adrian Gore is an agile leader and a visionary leader. He is globally recognised as an innovative thinker, and Discovery's model is disruptive in a range of industries and markets.

Agile leaders focus on identifying emerging digital opportunities or competitive threats. They are engaged, seek to understand the causes and effects of problems at hand and respond by adapting. At the same time, they are conscious of the need to provide guidance through a strong vision, as change often threatens to overpower strategy. Discovery Bank will be entirely technology-led in a market traditionally reliant on physical bank branches and ATM's. The bank has been built on the latest technology and it is bound to disrupt the banking industry in South Africa.[33]

For agile leaders, informed decision-making essentially entails making decisions based on evidence obtained from available data. These leaders use the best available sources of data and apply applicable analytics before making a decision. They rely on their experience and instinct when they are presented with inadequate or inconsistent data. Agile leaders place great value on digital technologies to gather and analyse data, and they are always on the lookout for new data sources to support their informed decision-making.

'Today's volatile and unpredictable business landscape, shaped by digital disruption, requires managers to adopt an agile leadership approach. Agile leaders exhibit high levels of humility, adaptability, vision and engagement. They also practice digital business agility through hyperawareness, informed decisionmaking and fast execution. Combining must-have competencies with these agile behaviours ensures that agile leaders are significantly well equipped to deal with today's disruptive business environment.'

Source: Wade, M.R. 2017. Agile leadership in an age of digital disruption. Available at https://www.imd.org/research-knowledge/articles/agile-leadership-in-an-age-of-digital-disruption. [Accessed 9 November 2018].

Fast execution entails the willingness on the part of a leader to move quickly: often speed trumps perfection. In an environment characterised by disruption, the effectiveness of awareness and informed decision-making is significantly reduced if the leader is not able to act with speed. Agile leaders can only be effective if they are able to execute an informed decision quickly, and to do so despite organisational, structural or monetary barriers.

Critical thinking

In an interview exploring the meaning of agility, several South African business leaders explained what agility means to them. Below are a few excerpts from their responses.

Wendy Luhabe, founder of the Women Private Equity Fund and chair of the African Leadership University said, 'Agility means being able to anticipate and being able to respond as opposed to reacting.' ... 'All organisations have to innovate constantly and remain relevant and useful. In my world – which focuses on the economic empowerment of women – we have to continuously identify innovative ways women could participate.'... 'Agility teaches us to be present' ... 'It requires that we decode what is needed and have the courage to provide a solution on the spot.'

Malusi Ndlovu, General Manager at Old Mutual Corporate Consultants, said, 'Agility is important when speed is of the essence. It's about achieving results in the quickest or most efficient way possible. There are two parts to it. First, there should be close engagement with the customer or end user, so that they are consulted from the beginning and right through the process, not just at the end. Secondly, people should be empowered so that decisions will actually be made.' He added, 'People and organisations across the board will have to become much more 'change fit''. ... 'Being agile means being able to deal with the changes that come at you while knowing that you don't always have to do or change something.'

Group Chief Executive Officer of Dimension Data, **Jason Goodall**, said agility has two pillars. 'The first is speed -- the ability to make swift decisions and to add resources and allocate funds faster. The second is the ability to change direction, to continually come up with new ideas and execute them quickly. Achieving both involve relooking at your decision-making criteria and having flat rather than hierarchical organisational structures, eliminating bottlenecks, and building empowered, often virtual, teams who understand and follow a process and methodology that encourages this kind of thinking.'

Source: van Dijk, M. 2018. Old Mutual Corporate. Inside the agile business. *Mindspace*, Issue 2. Cape Town: John Brown South Africa, pp.18-21. Reprinted by permission of John Brown Media and Old Mutual Limited.

9.4 Motivation

Employees (human resources) influence the organisation's productivity and profitability directly. To manage employees effectively, managers should understand what motivates the behaviour of their employees. This is a crucial aspect of the leading function.

In the context of this chapter on the leading function of managers, the definition of motivation is 'an inner desire to satisfy an unsatisfied need'.[34] It is an intrinsic process. Therefore, managers cannot 'motivate' their employees, but they can create a work environment conducive to employees being motivated to achieve organisational goals. Thus, from an organisational perspective, motivation is the willingness of an employee to achieve the organisation's goals.

The motivation process starts with an unsatisfied need and moves in a certain sequence.[35] For example, an employee has an unsatisfied need for higher status in the organisation. His or her motive is the desire to advance to a managerial position, which leads to certain behaviour, such as working overtime or enrolling for a management course. The consequence of the behaviour might be that he or she receives a promotion (or does not receive a promotion), which will lead to the satisfaction (or dissatisfaction) of his or her need. If dissatisfaction occurs, the need remains unsatisfied and the motivation process will start all over again. Satisfaction is usually short-lived because people have many needs and, as soon as one need is satisfied, another need will surface. If the person in the example advances to a first-line management position, he or she may very soon want a further promotion to a middle-management position. This will again cause dissatisfaction and the motivation process will start over.

If managers understand what motivates the behaviour of their employees, they can influence employees' work performance. Yet it is important to note that motivation is not the only factor that influences work performance. The variables that determine performance are motivation, ability (training, knowledge and skills) and the opportunity to perform (resources): [36]

Performance = Ability × Motivation × Resources

Effective managers understand that employees must possess a high level of motivation plus the appropriate training, knowledge and skills to perform effectively in each work situation. If employees lack the skills they need to perform, they will not be able to do their work properly, no matter how motivated they are. Organisations should provide employees with the opportunity to perform, which means that they must have adequate resources (such as tools, equipment, materials and supplies) to be able to do the work.

The above discussion emphasises the major role managers play in terms of the work performance of their employees.

The value of theories on leadership and motivation is that they provide managers with a better understanding of how to manage their employees to make them perform best. At the same time, these theories ensure that the organisation creates an environment where employees can satisfy their needs.

In modern organisations, managers also manage groups and teams. In our discussion thus far, we have concentrated on how managers lead individuals and create

an environment that motivates them to attain organisational goals. However, employees belong to groups that do much of the work in organisations, working in task groups and command groups. They also belong to informal groups.

Managers perform the leading function to manage groups such as the functional departments in an organisation to enable them to achieve the organisation's goals and objectives. In addition, managers of contemporary organisations need to create a special type of group, namely working teams, to perform a variety of tasks.

In view of the presence and importance of groups and teams in organisations, managers should understand the dynamics of groups and teams and know what **team leadership** entails. We investigate these aspects in the following section.

What motivates millennials

The millennial worker was born between the early 1980s and the early 2000s (different researchers cite different birth years). Millennials comprise a substantial percentage of the current workforce worldwide. They are active Snapchat users and are as concerned with posting to Instagram as they are with work-life balance. Characteristics of millennials in the workplace include self-confidence, digital savviness, the need for affirmation and the enjoyment of immediate gratification. These workers are also highly motivated to be successful, and they are very ambitious. Researchers conducting a study on what motivates millennials concluded that the following factors are relevant:

- **Growth potential**. Experience trumps all else. Many millennials want to become entrepreneurs, and they need to start somewhere.
- **Recognition** is key—happiness equals additions to their LinkedIn resumes and being given recognition in front of peers for a job well done.
- **Flexibility** was also at the top of their priority list because having autonomy and control over their own time at work is very important to millennials.
- **Ability to make an impact**. They want their work to matter.
- **Remuneration** – the last factor the millennials listed. They want to feel that they contribute to the larger picture and make enough money.

Source: Adapted from Scott, J. 2017. Motivating millennials in the workplace so they don't quit. Available at https://www.xactlycorp.com/blog/motivating-millennials-it-takes-more-than-money/ [Accessed 18 November 2018]. Reprinted by permission of Xactly Corp.

9.5 Groups and teams in organisations

The employees of modern organisations do not work merely as individuals with individual needs and goals, but also as members of groups and teams. To achieve the organisation's goals, managers lead groups and teams, as well as individual employees. The complexity of global organisations necessitates teamwork and team leadership. This is also true for top-level management. Mr Adrian Gore acknowledges that the success of Discovery is not only his achievement, but the effort of an incredible team, who built the company over the years.

Many writers use the words 'group' and 'team' interchangeably, but recent management literature makes a definite distinction between them, saying that while all teams are also groups, not all groups are teams. A team is a special kind of group, and changing groups into teams is a process that requires special management skills. This section first focuses on groups in general and then discusses work teams as an integral part of successful contemporary organisations.

9.5.1 Groups

A **group** comprises two or more individuals who regularly interact with one another and who work for a common purpose. People join groups for a variety of reasons, ranging from satisfying their social needs to achieving goals that are impossible for them to achieve as individuals. Some people join groups to achieve some level of prestige or status. Others feel that they enhance their self-worth by belonging to a specific group. Individual group members often feel they have more power by joining a group because group action can achieve more than individual action.

In organisations, there are two types of groups, namely informal and formal groups.[37]

9.5.1.1 Informal groups

Informal groups can be interest groups or friendship groups:

- In interest groups, the group members usually share a common interest. For example, a group of employees might campaign for better cafeteria facilities at their workplace. When the organisation provides better facilities, the group will disband.
- Friendship groups usually exist to satisfy the social needs of their members. For example, a group of employees might play bridge once a week.

9.5.1.2 Formal groups

Formal groups are categorised as command groups or task groups:

- Command groups appear on the organisational chart, which indicates their line of authority, for example, from managers to their employees. The organisation's structure defines formal groups in terms of allocated work assignments that determine tasks, and the formation of work groups.
- Organisations create task groups to complete a specific task or project in the organisation. After completion of the task, the group disbands. Organisations can create task groups across hierarchical boundaries. For example, the dean of a university's College of Management Sciences might appoint a committee comprising staff members from the production department and the editorial department as well as junior and senior academics to investigate the quality of the study material produced for all departments in the college. On completion of the project, the group will disband.

9.5.2 The characteristics of groups

Every group in an organisation is different in terms of its structure or set of characteristics that shapes the behaviour of both the group and the individual group members,[38] for example, the size of the group, the composition of the group, group norms and group cohesiveness:

- **Group size** affects the group's overall performance. If the group is too big, social loafing occurs – the tendency of individuals to put in less effort when working in a group than when working individually. Thus, group size has an influence on the productivity of groups.
- **Group composition** can influence a group's performance. Heterogeneous groups (with members who are diverse in terms of, for example, gender, race and nationality) have more difficulty working together at first, but they outperform homogeneous groups over time.
- **Group norms** are standards shared by members of a group that develop from interaction between these members. Norms can be positive or negative, and managers should manage them. An example of a positive norm is that the group strives to outperform other groups; a negative norm is: 'We only do what is asked of us – no more, no less'.

•**Group cohesiveness** is the way in which a group stands together as a unit rather than as individuals. There is a strong relationship between performance norms and cohesiveness, which can be either beneficial (work according to positive norms) or detrimental (work according to negative norms) to the organisation. If a group is very cohesive, the members' adherence to group norms will be stronger.
•**Status** in groups can be formal or informal, meaning that groups sometimes give higher (informal) status to group members who are relatively low on the hierarchical level of the organisation. Such status derives from factors such as the age or experience of a group member, or the social influence of a group member.
•The **formal leader** in a group usually has a title such as section or department manager, supervisor, project leader or committee chair. However, sometimes an informal leader has more influence in a group, which may influence the performance of the group positively or negatively.

To manage groups in an organisation effectively, managers should understand the structure of groups and how the various characteristics of specific groups influence the organisation's performance.

Managers should not underestimate the role of groups in the overall accomplishment of organisational goals. They should understand group dynamics to manage the groups in their organisations effectively.

9.5.3 Teams

As stated earlier, not all groups are teams. A **work group** is a unit of two or more people who interact primarily to share information and make decisions that will help each group member perform within his or her own area of responsibility.[39] Individual members of work groups are accountable and rewarded for their own performance. However, a **work team** 'comprises a small number of employees with complementary competencies who work together on a project, are committed to a common purpose and are accountable for performing tasks that contribute to achieving an organisation's goals'.[40] Work teams perform *collectively, and members are dependent on each other* to complete their work, while workgroup members only share information. An example of a work group is a pool of administrative clerks. One clerk's performance appraisal and rewards are not dependent on the performance of the other clerks. Furthermore, the group's performance is the sum of the group members' individual performances.

An example of a work team is a team tasked with developing a new product from conception to completion. All the members are dependent on each other because the output of one member becomes the input of another member.

While work groups have neutral and sometimes negative **synergy**, work teams have *positive synergy*, meaning that the performance of an effective team can be greater than the sum of the performance of individual team members. For example, the efforts of the team tasked with developing a new product can amount to more than the sum of their individual performances because they are creating something new.

Whilst group members are only accountable for their own performance, *team members are individually and mutually accountable* for the performance of the team. In the above example of the product-development team, the team members are mutually responsible and accountable for the new product but are also individually accountable for their own inputs.

Lastly, while the skills of the members of work groups are random and varied, the *skills* of members of work teams are *complementary* because of the interdependent nature of their work.[41]

Work teams have many advantages, but it is wrong to perceive them as a cure-all solution to organisational problems. Teams are not suitable in all organisational settings. Teams are effective only in organisations in which the organisational culture is conducive to teamwork. Furthermore, the organisation's reward system must reward team performance. Top managers' commitment and support for teams must be evident throughout the organisation, and the work at the organisation should be suitable to perform in a team environment.

Yet, despite these considerations, teams are gaining popularity throughout the world and complex global organisations cannot function without effective teams. The following are the different types of teams:[42]

- **Problem-solving teams** comprise employees from the same department who meet regularly to discuss ways of improving quality, efficiency and the work environment.
- **Self-managed work teams** take on the responsibilities from their former managers, including tasks such as planning, scheduling and control. Team members address problems in the work process – sometimes, even, the selection of team members and discipline.
- **Cross-functional teams** comprise employees at the same hierarchical level, but from different work areas, who come together to accomplish a task. These teams are effective in allowing people from diverse areas in an organisation to exchange information, develop new ideas, solve problems and co-ordinate complex projects. Task forces and committees are common examples of cross-functional teams.

High-performance teams have several characteristics in common:

- A clear understanding of the team's goals, and the technical skills and abilities needed to achieve these goals.
- Members who can adjust their skills.
- High mutual trust among members and unified commitment.
- Good communication and adequate negotiating skills.
- Team leaders who encourage team members by clarifying goals, and who help members to realise their potential.[43]

Key problem areas identified in South African teams

The main focus of a study conducted to investigate the performance of work teams in corporate South Africa was to identify key problem areas occurring in teams. The sample included 150 South African organisations, of which more than 50 per cent responded. A common set of problems affecting the majority of work teams emerged. The themes or factors explained why teams are not effective, or fail to achieve their objectives. The table below list these contributing factors, ranked from the **most important** (1) to the **least important** (10) reason.

1. Lack of trust
2. Weak task leadership
3. Poor implementation/'no follow through'
4. No focus
5. Poor interpersonal skills
6. Lessons and mistakes not acknowledged
7. Poor interpersonal chemistry
8. False commitments from team members
9. Working in silos
10. Lack of management support

The results indicate that trust, leadership and follow through are key reasons why teams are not effective. These results emphasise the importance of trust-building processes in leader-

follower relationships. The influence of a trusting relationship impacts on the performance of teams, conflict, change, communication and diversity management.

Source: Steinmann, N. & Martins, N. 2002. South African teams. In *Peoples Dynamic*. Available at http://www.peoplesdynamic.co.za/articles.html. [Accessed 18 November 2018]. Reprinted by permission of Niel Steinmann of People's Dynamic Development.

One more aspect of using teams in organisations is **team leadership**. According to Belbin,[44] the effective team leader limits his or her role and is inclined to delegate and not interfere with the way in which team members do their work. However, team leaders concentrate on outcomes. Team leaders build on diversity and seek talent – the team leader welcomes people with special abilities to improve the balance of the team. Team leaders develop team members by building on their strengths. Effective team leaders fulfil a leadership role by projecting the vision and formulating a mission, thereby creating a 'map' according to which each team member can contribute in his or her individual manner to the attainment of team objectives.

Managers communicate their organisations' visions, missions, goals, strategies, plans, problems and expectations to employees. They also listen to employees' problems and aspirations. The ability to communicate effectively is an important element of leading. The following section describes a simple communication model. The discussion of communication appears here as another element of the leading function because effective communication is an essential part of effective leadership.

9.6 Communication

Communication is an essential element of leading. Effective leadership depends on constant communication between leaders and their employees. It is important in building and sustaining relationships in an organisation.

Good communication is conducive to good relations between managers and individual employees, groups, teams and, ultimately, the organisation and its environment. Managers devote a considerable proportion of their time to communicating with the organisation's stakeholders, both inside and outside the organisation. Furthermore, the management process is dependent on effective communication.

Theoretically, communication is the transfer of information or messages from one person to another. Figure 9.4 illustrates a simple communication model, which provides a basis for understanding the key elements of interpersonal communication.

The sender is the source of a message. To communicate effectively, the sender should know exactly what the message is that he or she wishes to transmit. The sender should take care with his or her choice of words and their meaning and should encourage two-way communication by showing insight into the receiver's perceptions.

The message may convey ideas, opinions, plans, orders or explanations. In the interests of effective communication, the message should be simple and clear.

The communications channel is the way the message reaches the receiver. It may assume any form that the recipient's senses can perceive it, if it is comprehensible. For example, the recipient can hear spoken language, see, or feel gestures and read the written word.

The receiver of the message should absorb the message and show that he or she has received and understood the message (listening skills are important here).

For communication to be effective, the recipient should receive the message unimpeded, meaning that the recipient should understand the message in accordance with the sender's intentions.

Because effective communication is so important in leadership, managers should remove all hindrances that may affect the clarity of their messages, such as obscurity, language differences, erroneous perceptions, doubts about the source or sender and ambiguities. Managers should promote effective communication by encouraging feedback and by using face-to-face communication wherever possible. Managers can enhance their communication by using simple language. They should contemplate any symbolic content in their communication before sending the message.

Figure 9.4: A basic communication model

Listening

Listening is a crucial component of effective communication. A good listener:

- stops what he or she is doing and gives his or her complete attention to the speaker;
- avoids distractions such as fiddling with pens;
- stays 'tuned in' (not letting his or her mind wander);
- does not assume that he or she knows what the speaker is going to say and does not jump to conclusions;
- listens to the entire message without interrupting the speaker;
- asks questions if he or she feels he or she has incomplete information;
- takes notes to help him or her remember the message and to document it, if necessary;
- conveys meaning – for example, uses verbal clues to let the speaker know that he or she is listening (such as nodding, making eye contact or saying, 'I see' or 'I understand'); and
- look for non-verbal cues such as body language and eye expression (sometimes people say one thing and mean something else, which may appear as a non-verbal cue).

9.7 Summary

To be successful, organisations need managers who are also good leaders. Managers perform the leading function to manage the human resources in their organisations effectively. They use authority and power to influence their employees to strive willingly to achieve organisational goals. Leadership theories help managers to understand what leadership entails. In this chapter, we examined the most important categories of leadership models as well as contemporary issues in leadership. Effective managers should understand how their employees' behaviour is motivated. Modern organisations use work groups and work teams extensively, and managing them is an added responsibility of contemporary managers. Communication is a crucial element of the leading function, without which a manager will not be a good leader.

Small business perspective: Leading in the small business organisation

The leading function of managers in big organisations with several levels of management and a definite chain of command differs from the leading function of owners or managers in small business organisations, which can function successfully with only one level of

management where the owner or manager communicates directly with employees.[45] In small businesses the personal involvement of the entrepreneur with employees can influence the success of the business, because ‘if the employer-employee relationship is good, employees in small businesses develop strong feelings of personal loyalty to their employer’.[46] The strength of a small business may very well depend on the relationship of the owner–manager with employees and his or her willingness to create a work environment in which employees are motivated to attain the objectives of the business. The delegation style of a manager, whether he or she is employed by a large organisation or is the owner–manager of a small business, is a crucial element of the leading function. Effective leaders delegate to employees the authority to use organisational resources and the responsibility to perform their delegated tasks, while they, themselves, remain accountable for the completion of the tasks. Failure to delegate may be the reason many businesses never grow beyond a small business where the owner can directly supervise everything in detail.[47]

KEY TERMS	
accountability	management versus leadership
agile leadership	managerial grid
authority	path-goal model
autocratic leadership style	personal power
behavioural leadership theories	peer to peer leadership
charismatic leadership	position power
coercive power	power
concern for people	production-oriented leadership sty
concern for production	referent power
democratic leadership style	responsibility
emotional intelligence	reward power
employee-oriented leadership style	servant leader
expert power	synergy
Fiedler’s contingency theory of leadership	team leadership
formal group	trait theory
Fourth Industrial Revolution	transactional leadership
Hersey and Blanchard’s situational leadership model	transformational leadership

informal group	trust
laissez-faire leadership style	visionary leadership
leadership	work maturity
legitimate power	

Questions for discussion

1.How would you define the leading function of managers?
2.How does Mr Gore, the Chief Executive Officer of Discovery see his leadership role?
3.Are managers also leaders?
4.Explain the differences between managers and leaders.
5.Mr Gore, the Chief Executive Officer of Discovery, is an agile leader. Discuss.
6.What are the components of leadership?
7.Why are managers who use power effectively strong leaders?
8.What are the shortcomings of trait theory and the behavioural theories?

Multiple-choice questions

1.Which statement is false?
a.Leadership is about bridging the gap between formulating plans and achieving goals.
b.The behavioural approach to leadership focuses on how leaders should behave in a specific situation.
c.According to Fiedler's theory of leadership, how well a leader's style fits the situation determines his or her effectiveness.
d.House developed the path-goal theory.

2.Group _________ can influence the group's adherence to group norms positively.
a.size
b.composition
c.leadership
d.cohesiveness

3.Which one of the following is not a characteristic of a high-performance team?
a.High mutual trust among members
b.Adequate negotiating skills
c.Working in silos
d.Members who can adjust their skills.

4.A _______ is tasked with developing a new product from conception to completion.
a.formal group
b.work team

c.work group
d.team leader

5.________ leadership is the ability of a leader to be able to lead in a wide range of circumstances.
a.Servant
b.Agile
c.Peer to peer
d.Ethical

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CHAPTER 10

Controlling the management process

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The purpose of this chapter

Control is the last of the four fundamental functions of management. It is the final step in the management process, where the assessment of actual performance against planned performance initiates a new cycle of planning, organising, leading and control. This chapter deals with the purpose of control and examines how the control process works. It also examines the areas of control that management should focus on, such as the control of physical resources, quality control, financial control, budgetary control, the control of information and the control of human resources. The characteristics of an effective control system are also briefly examined.

Learning outcomes

On completion of this chapter you should be able to:

- give an overview of the purpose of control
- describe how a control process should function
- explain the various types of control
- discuss the characteristics of an effective control system.

10.1 Introduction

Organisations use control procedures to ensure that they are progressing towards their goals, and that their resources are being used properly and productively. This chapter examines the final component of the management process: **controlling**. Although it is the final step in the management process, it forms the basis for a new cycle of management activities because it gives feedback about, and influences the first step in the management process (planning). Without any knowledge of how successfully the plans were implemented or how effectively the goals were achieved, managers would not be able to start the next management cycle of planning, organising, leading and, ultimately, controlling.

Brilliant plans may be formulated, impressive organisational structures may be created, and good leadership may be applied, but none of this ensures that the activities will proceed according to plan or that the goals and carefully laid plans will, in fact, be realised. An effective manager is therefore someone who follows up on planned activities, seeing to it that the things that need to be done are carried out and that the predetermined goals are reached. The control process can be defined as the process of establishing and implementing mechanisms to ensure that the objectives of the organisation are achieved. Managers at all levels and in all departments should be involved in the process of control. Until the activities of individuals, departments or units are evaluated (in other words, until **actual performance** is compared with the standard required), management will not know whether activities have been executed

according to plan and will be unable to identify weaknesses in their plans. Controlling means narrowing the gap between what was planned and the actual achievement of management, and ensuring that all activities are carried out as they should be. The management process takes place between planning and control. Successful management is often dependent on sound planning and effective control.

The case study that follows provides an illustration of the importance of effective control mechanisms in an organisation, and the alignment that should exist between planning and control activities in an organisation.

CASE STUDY: NEDBANK

Nedbank's history can be traced back to the early 19th century with the establishment of the Cape of Good Hope Bank in 1831. Following successive branding and structural changes, from The Nederlandsche Bank voor Zuid-Africa to the Netherlands Bank of South Africa, to the Nedcor Group in the 1980s, the Nedbank Group was formed in 2003. Nedbank regards 2004 as a watershed year for the group as both structural and strategic changes were implemented to restore its performance and lay the foundation for sustainable growth into the future. In this year, Nedbank was faced with considerable challenges and a highly uncertain future. In the previous year, the Nedcor Group was formed, combining Nedcor, BoE, Nedcor Investment Bank and Cape of Good Hope Bank. In 2004, the bank was losing market share, headline earnings were down 98 per cent with a return on equity of only 0,4 per cent. Nedbank was considered the lowest of the top banks in South Africa, who were all on an upwards trajectory compared to Nedbank's decline. Nedbank's reputation was at an all-time low. During this time, Tom Boardman was appointed as CEO and was tasked with taking control of and rebuilding Nedbank. On the day of the announcement of his appointment, the bank's stock prices dropped by 6 per cent. However, the new CEO had a plan which entailed a complete overhaul of the way the company did business. Boardman formulated the following goals: regain market share in key retail product areas and penetrate the mass market; retain leading positions in key wholesale market segments and grow the business banking franchise; reposition and stretch the Nedbank brand for broader market appeal; become a bank for all South Africans; and become the best place to work for in the financial services sector.

The core business strategy of the bank informed a redefinition of its brand and the supporting marketing initiatives, anchored in the restated vision '[t]o become Southern Africa's most highly rated and respected bank … by our staff, clients, shareholders, regulators and communities'. However, in order to be successful, Tom Boardman and Nedbank understood that, in order to realise the vision, the bank needed to change and undergo a learning process. In addition, they also realised that this new vision needed to be supported by a strong strategy and a uniting set of values. Workshops were launched to implement strategies at lower levels of management. Control measures were then taken to ensure that Nedbank attained its 'Journey Back to the Top'.

The outcomes of the control measures taken by Nedbank, and the implementation of its turnaround strategy were remarkable. Since 2005, staff at Nedbank have worked together in a co-operative fashion. A measure of this is a decrease in the entropy score, which has fallen from 25 per cent in 2005 to 13 per cent in 2009 (entropy is a universal property of systems and refers to their tendency to run down and die). The bank realised their targets of 20 per cent return on equity and 55 per cent cost-to-income ratio. They also had the highest shareholder return of all the 'Big Five' South African banks in 2009. However, Nedbank continues to face challenges. Market conditions within the financial industry are still marked by instability and ongoing uncertainty. In 2010, Nedbank had a change in leadership with the appointment of Michael W T Brown as the new CEO, following the retirement of Tom Boardman. Under its new leadership, Nedbank is still anchored in the vision, values, objectives and strategies as formulated by Tom Boardman and his management team, which are strongly supported by all employees of the bank. Despite the environmental

challenges, Nedbank continues to thrive on the strong control measures that were taken during a time when the bank most needed it.

Sources: Adapted from Nedbank Group. Our history. 2018. Available at https://www.nedbank.co.za/content/nedbank/desktop/gt/en/aboutus/about-nedbank-group/who-we-are/Our-history.html [Accessed 20 April 2018]; Barrett Values Centre. 2010. Case Study: Nedbank. Available at https://www.valuescentre.com/sites/default/files/uploads/2011-07-29/Barrett%20Nedbank%20Case%20Study%20final.pdf [Accessed 20 April 2018].

10.2 The purpose of control

An organisation needs a control process because even the best-laid plans may go wrong. In the case of Nedbank, a new vision, plans and strategies were formulated during its watershed year when the Group performed financially very poorly. During this time, Nedbank faced an uncertain future, and its reputation was at an all-time low. Tom Boardman, as CEO of the bank, took control and started to rebuild Nedbank.

A control process is necessary for the following reasons:

- Control is linked with planning, organising and leading. Planning is the first step in control. Without control, planning is pointless.
- Control helps companies adapt to environmental change (the business environment was discussed in detail in Chapter 4). It enables management to cope with change and uncertainty. If an organisation is to reach its goals according to plan, control is necessary. The variables in the turbulent contemporary business environment mean that an organisation is seldom able to realise its goals strictly according to plan. Raw materials may not be delivered on time, labour unrest or defective machinery may delay the organisation's operations, unexpectedly high interest rates may affect the cost structure, and so on. Without control, the impact of environmental change on the organisation is difficult to detect.
- Control helps to limit the accumulation of error. Managers and employees are capable of making poor decisions and committing errors. An effective control system should detect such errors before they accumulate and become critical.
- Control helps companies to cope with increasing organisational size and complexity. As a business grows, more people are employed, new products are developed, new equipment is bought, new industries are entered, and branch offices are opened as the activities of the business expand into different geographical regions. Over time, the business becomes an extensive network of activities that include production, finance, administration, staff and marketing. Without an effective system of control, it would be extremely difficult to spot weak points in a highly complex network and rectify them in good time.
- Control helps to minimise costs. When implemented effectively, control can help to reduce costs and increase output. For example, by controlling the raw materials used in an organisation, potential problems can be anticipated and prevented, thus reducing production costs and improving outputs.

An overview of the control process will clarify the importance of control.

10.3 The control process

As mentioned in the introduction, control is the process by which management ensures that the organisation's goals are accomplished or that actual performance compares favourably with predetermined standards. This process comprises four steps (see Figure 10.1).

The control process includes setting standards against which actual performance can be measured, measuring actual performance, evaluating any deviations that might occur and taking steps to rectify deviations. Each of these steps is discussed below.

Figure 10.1: The control process

10.3.1 Step 1: Establish standards

The first step in control is to establish performance standards at strategic points. Because of the close relationship between planning and control, it may be said that control begins at the planning stage. It is often difficult to distinguish between these two functions of management because, in a sense, control means revised planning and the revised allocation of resources. The control system should therefore be a mirror image of planning, as the plans indicate the goals and setting of standards or norms necessary for control.

A performance or control **standard** is a planned target against which the actual performance will be compared. A building project that has to be completed by a certain date will have control standards at strategic stages, such as completion of foundations by 31 March, completion of concrete structure by 30 June, completion of roof by 15 June and so on.

To make the control process possible and worthwhile, the performance standard should be relevant, realistic, attainable and measurable, so that there can be no doubt as to whether the actual performance meets the standard. Although it is difficult to make generalisations about suitable performance standards for different businesses, it should be possible in any particular business to convert strategy into comprehensive plans and goals. From these, appropriate performance standards can be developed, for example:

- Profit standards indicate how much profit the business expects to make over a given period.
- Market-share standards indicate what share of the total market the business is aiming to conquer.
- Productivity standards are indicated by expressing inputs and outputs in relation to each other as ratios. Such ratios indicate the relative productivity with which tasks are performed.
- Staff-development standards indicate the effectiveness of training programmes for staff.
- Standards are a function of the goals that are set in the planning phase. Performance standards, of which the above examples are only a few, enable management to distinguish between acceptable and unacceptable performance. They also enable management to monitor strategies and goals. To be effective, these standards should be the responsibility of a particular individual at some strategic point.
- In the case of Nedbank, Tom Boardman formulated various new standards in terms of market share, the bank's position in key wholesale market segments, and the bank as an employer in the financial services sector.

10.3.2 Step 2: Measure actual performance

The collection of information and reporting on actual performance are continuous activities. As in the case with performance standards, it is also important for the activities to be **quantifiable** before any valid comparisons can be made. Another important requirement regarding the measurement of actual achievement is that the reports should be absolutely **reliable**. Unless they are totally accurate, control will not be effective. Moreover, observation and measurement must be carried out at the necessary strategic points and according to the standards determined by the control system.

Important considerations in the measurement and reporting of activities are which information and how much information should be fed back, and to whom. In a small business or at the lower-management levels of a fairly large business, operational management is more or less fully informed, and this is not of vital importance. But as a business increases in size and information about activities has to be transmitted to higher levels, the question of control becomes more important. It is at that point that the principle of **control by exception** is applied. This means that only important or exceptional disparities between real and planned achievement are reported to top management. Less important deviations are dealt with by employees.

Management information is presented to indicate the disparities between performance standards and actual performance, and to enable management to concentrate on deviations or problem areas. For example, management might be highly satisfied with a report indicating that sales are 10 per cent higher than in the previous year, but they are likely to feel less complacent about the fact that sales of the company's market leader have shown a drop of 10 per cent. The lapse of time between performance and measurement must be kept to the minimum so that deviations may be spotted as early as possible.

In the Nedbank case study, actual performance was measured in terms of the bank's financial performance (for example, return on equity and cost-to-income ratio) as well as measures of staff working together in a co-operative way (as measured by the entropy score).

10.3.3 Step 3: Evaluate deviations

This step comprises the determination of the performance gap between the performance standard and actual performance. It is important to know why a standard has only been matched and not exceeded, or even why performance has been much better than the standard. This could, for example, be the result of a new trend in the business environment, which might then be exploited more effectively. The nature and scope of the **deviations** responsible for the so-called performance gap may have various causes. In some cases, the causes may be fairly obvious. In other cases, the causes may be so obscure that it becomes difficult to identify them. It is therefore impossible to make generalisations about the causes of disparities between actual performance and standards.

Firstly, it is necessary to make sure that the disparities are genuine. In other words, it must be determined whether both the performance standard and the actual performance have been set and measured objectively. If the standard is set too high, further examination of apparent deviations may be a waste of time.

Secondly, it must be determined whether the deviations are large enough to justify further investigation. Upper and lower limits should be set for each deviation, and only those deviations that exceed the limits should be subjected to further examination.

Thirdly, all the reasons and activities responsible for the deviation should be identified.

At this point, decisions about corrective action, the last step in control, must be taken.

10.3.4 Step 4: Take corrective action

The final step in the control process is to determine the need for **corrective action** and to ensure that deviations do not recur. If actual achievements match the standards, then, of course, no corrective action is needed, provided that standards have been set objectively. If actual achievements do not match the performance standards, management has a choice of three possible actions:

- Actual performance can be improved to reach the standards.
- Strategies can be revised to accomplish the standards.
- Performance standards can be lowered or raised to make them more realistic in the light of prevailing conditions.

In the Nedbank case study, the outcomes of Tom Boardman's implementation of corrective action were remarkable. The bank's financial performance, staff morale and corporate culture improved. This contributed to the sustainability of the bank in an uncertain environment.

Step 4 completes the cycle of the control process. Corrective action is, in a sense, the point of departure for the next cycle in the management process. However, the term 'control' has different meanings for different people. It often has a negative connotation for people who feel that their freedom and initiative are being restricted. It is therefore important to maintain a balance between control measures and control of people. It should also be remembered that there are limits to the time and money that can be spent on control. Moreover, control should be continually adapted to changing circumstances.

The Nedbank case study is an example of the positive outcomes of implementing the control process. The following case study illustrates the consequences of the absence of a control process at another South African bank.

CASE STUDY: The collapse of African Bank Investments Limited (Abil)

African Bank Investments Limited (Abil) was co-founded by Leon Kirkinis in 1999. He has been described as one of the sharpest minds in banking, who changed South Africa by expanding credit to the poor. From 1999 onwards, Kirkinis built Abil into the country's largest granter of loans that were not backed by collateral. Styling himself as a visionary for lending to South Africans ignored or deemed too risky by conventional banks, Kirkinis fuelled profits by granting loans at annual interest rates as high as 60 per cent.

Abil did not take deposits, relying instead on stock and bond markets to fund its lending. It was one of the most desirable stock on the Johannesburg Stock Exchange for most of the first decade of this century. The company's share price rose from around R5,25 per share in 2003 to more than R22,50 per share in 2008. It also offered investors a very appealing cash dividend. At its peak, Abil traded on a dividend yield of over 9,0 per cent. Under the leadership of its charismatic CEO, Leon Kirkinis, Abil was reimagining what micro lending could do in South Africa, and seemed to prove that this was not only a viable business model, but also a very profitable one. Between 2003 and 2008, Abil more than doubled its annual profits from R660m to R1,56bn. In 2008, Kirkinis unilaterally took the decision to buy Ellerines (a retail furniture company) for R9,1 billion, without proper due diligence or full board approval. In a 2012 statement, Kirkinis attributed the company's success to having 'built a robust, well capitalised and flexible business to position us as the market leader in a larger, more competitive unsecured credit market'. In the same year, Kirkinis was ranked the

37th wealthiest person in South Africa in the annual Sunday Times Rich List. Little did Kirkinis know how the fate of the company would change in the years to come.

Abil became more vulnerable with the deterioration of its target market, caused by protracted mining strikes which began in 2012. As strikes crippled the South African platinum industry, miners began to default on loans. In February 2013, Abil was charged with reckless lending from the credit regulator, and in October 2013 it paid R20m to settle a case after an investigation found that the bank had advanced at least 700 loans without first carrying out affordability assessments. In the same year, the central bank said in a statement that it told Abil to sell Ellerines, which was losing at least R70m per month. Kirkinis had other plans; he wanted to keep Ellerines and the distribution network that the retailer provided for loans. Through six years of declining sales, Abil continued to try and make Ellerines viable by searching for a retail partner, a partner that was never found. Ellerines applied for business rescue in August 2014.

In August 2014, Abil's shares were suspended on the JSE. The South African Reserve Bank (SARB) put the underlying business under curatorship, which few shareholders had anticipated. Less than a year earlier Abil had raised R5,5bn in a rights issue that was widely supported, even though it was already apparent that the company had severely underestimated its bad debts. Within months, these had sunk the business, and shareholders would have been left with nothing had the SARB not stepped in.

The Myburgh Report, which analysed the reasons for Abil's collapse, made some very uncomfortable findings. Financially speaking, not making sufficient provision for bad debts, and engaging in unsustainable lending had led to the bank's collapse. The Myburgh Report also found that Kirkinis had an overwhelming influence over the board and the operations of the bank. Essentially, no one questioned him. The starkest example is that he had unilaterally made the decision to buy Ellerines for R9,1bn, without proper due diligence or full board approval. In hindsight, many asset managers were also far too eager to believe what Kirkinis was telling them. They continued to believe him until it was too late. In addition, certain members of the board did not have the appropriate competence or knowledge of banking. The board was also extremely small for a banking board, with too many executive directors. This left no real room for challenging independent voices. This is really the crux of the African Bank lesson – that no analysis of African Bank was truly complete without a thorough analysis of its corporate governance. This case stands out as one of South Africa's most high profile corporate failures – offering us an opportunity to learn from mistakes to ensure that history does not repeat itself. Since the SARB put Abil under curatorship, various control measures have been implemented, of which taking deposits and only engaging in sustainable lending are probably the most important. These measures have saved the bank and made it possible to continue operating.

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10.4 Types of control

In the introductory discussion of control, it was stated that organisations use control procedures to ensure that they are progressing towards organisational goals and that resources are being used properly and productively. But what exactly should be controlled to ensure that an organisation is progressing towards its goals?

This section focuses on the different areas and levels of control in an organisation.

10.4.1 Areas of control

As a rule, management should identify the key areas to be controlled. These are the areas responsible for the effectiveness of the entire organisation. For example, the

production department of a manufacturing organisation is a key area, as is the purchasing department of a chain store. Generally, a small percentage of the activities, events or individuals in a given process are responsible for a large part of the process. Thus, 10 per cent of a manufacturing organisation's products may be responsible for 60 per cent of its sales, or 2 per cent of an organisation's personnel may be responsible for 80 per cent of its grievances. By concentrating on these strategic points, for example, the organisation's main activities are exposed to control. The Nedbank case study showed that by successfully making strategic and structural changes, Tom Boardman turned Nedbank around.

Most organisations define areas of control in terms of the four basic types of resources they use. Generally, human, financial, physical and information resources are deployed to accomplish specific goals, especially those revolving around profitability. Control should therefore focus on the effective management of these resources. Figure 10.2 illustrates these four key areas of control:

1. Physical resources, which entails factors such as inventory control and quality control.
2. Human resources, which involves orderly selection and placement of employees, control over training and personnel development, performance appraisal and remuneration levels.
3. Information sources, which relates to accurate market forecasting, adequate environmental scanning and economic forecasting.
4. Financial resources.

Note that in Figure 10.2, financial resources are situated at the centre of the other three resources because they are controlled in their own right (for example, cash-flow or debtor control) and because most control measures or techniques (for example, budgets, sales, production costs, market share and various other magnitudes) are quantified in financial terms.

Figure 10.2: Key areas of control

The four focal points of control are discussed in greater detail below.

10.4.1.1 The control of physical resources

An organisation's physical resources are its tangible assets, such as buildings, office equipment and furniture, vehicles, manufacturing machinery and equipment, trading stock, raw materials, work in process and finished products. Various control systems of an administrative nature can be established to control physical resources (in particular, office furniture, equipment and vehicles) that normally appear on an asset register. Control systems for these resources involve usage procedures, periodic inspections and stocktaking, which often fall within the ambit of the internal audit. The control systems for inventories, raw materials and finished products are inventory control and quality control. Although inventory control falls within the field of purchasing and logistics management, it is necessary to make a few remarks about it here.

INVENTORY CONTROL

Inventory refers to the reserves of resources held in readiness to produce products and services, as well as the end products that are kept in stock to satisfy consumers' and

customers' needs. It normally refers to the four basic kinds of inventory (raw materials, work-in-process, components and finished products), but it need not only have to do with manufacturing. For an airline, a seat on an aircraft is inventory and an unsold seat on a flight is a loss. By the same token, money in a safe in a bank is inventory that can be lent to clients at a certain interest rate. Organisations keep inventories – and here the word is used in a wide sense – mainly for the following purposes:

- To satisfy the needs of customers and consumers;
- In the case of raw materials and components, to keep uncertainties regarding delivery and availability to a minimum so that the manufacturing process is not interrupted; and
- As a hedge during times of high inflation.

The following three control systems are relevant in the control of inventory:

1. **Economic-ordering quantity (EOQ)**, in use as early as 1915, is based on replenishing inventory levels by ordering the most economic quantity. The disadvantage of this control system is that inventory must be kept, regardless of the needs of the manufacturing department or customer, for particular raw materials, components or finished products. This means that items must be kept in stock for indefinite periods in spite of efforts to keep inventory costs as low as possible.
2. **The materials-requirements planning (MRP)** system was developed in the 1960s to eliminate the shortcomings of the EOQ control system. With this system, an estimate is made of the demand for raw materials and the components necessary to create a finished product. Inventories are ordered only when they are needed and the costs of maintaining inventory levels over extended periods of time are thus eliminated.
3. **The just-in-time (JIT) system is a refinement of the MRP system**. It originated in Japan, where it was developed by Toyota in the 1970s. The JIT philosophy is the same as MRP in the sense that organisations endeavour to manufacture products without incurring significant inventory costs. However, in contrast to MRP, where the need for raw materials and components is estimated and they are ordered according to demand, JIT is based on the premise that actual orders for finished products are converted into orders for raw materials and components, which arrive just in time for the manufacturing process. A manager applying the JIT principle orders materials and components more often in smaller quantities, thereby reducing risk and investment in both storage and actual inventory.

An element that is closely intertwined with inventory control is quality control.

QUALITY CONTROL

Quality has become an increasingly important issue in management. The Tylenol incident at Johnson & Johnson inspired the pharmaceutical-, food- and consumer-product industries to introduce improved quality-control methods. The management approach that emphasises the management of quality is known as **total quality management (TQM)**. Because of its importance, particularly in competitive international markets, it is necessary to give a brief overview of **quality control.**

Japanese products were once regarded as cheap goods. Today, however, the quality of Japanese products is acknowledged globally. Because of the success of Japanese products, especially in the United States, western managers are realising, increasingly, that access to international markets depends not only on mass production, but also on quality. Whereas quality control was formerly the responsibility of a single department

or section, TQM means that quality is the responsibility of everyone in the organisation, from the chairman of the board of directors down to clerks, purchasing managers, engineers, and selling and manufacturing personnel. TQM emphasises how managers can continuously improve an organisation's work systems so that its products and/or services are better able to deliver the quality desired by customers.

William Edwards Deming is known as the founder of the quality movement. The example that follows illustrates Deming's approach to the implementation of control systems in organisations.

A strategic commitment on the part of top management will ensure that quality is included in the mission statement of the organisation and transmitted to operational levels. The ultimate test of product quality is in the marketplace, where it becomes evident whether the product satisfies consumers' needs. The discussion of the control of the organisation's physical resources highlights the complexity of controlling physical resources as well as the importance of control in the success of the organisation. Aspects of control are expressed mainly in financial magnitudes. Control of the organisation's financial resources is the next topic of discussion.

10.4.1.2 The control of financial resources

An organisation's financial resources are the second group of resources that management must control. Financial resources and abilities are vital to the success of the organisation and are at the heart of the control process, as Figure 10.2 indicates. While financial resources are a group of resources in their own right, the control of financial resources is central to the control of other resources of the organisation. Financial control is concerned with the following aspects:

- Resources as they flow into the organisation (for example, returns on investments);
- Financial resources that are held by the organisation (for example, working capital and cash); and
- Financial resources flowing out of the organisation (for example, the payment of salaries and other expenses).

Each of these categories of financial resources is controlled so that revenues are sufficient to cover expenses and show a profit. Incoming funds, which normally represent revenue in the form of electronic transfers, cheques and cash, must be controlled rigorously because this is an area in which fraud is often experienced. Funds that are held by the organisation, such as working capital, should not be tied up in areas such as outstanding debtors or slow-moving inventory. Of equal importance is the control of outgoing funds (for example, salaries and expenses), which is also an area where fraud and serious errors may be found.

Financial-management principles that deal with cash flows, cash management, investment returns and so on can also be regarded as financial-control measures, but it is beyond the scope of this chapter to deal with these issues in detail. However, since financial control is pivotal to the control process, we will examine two instruments of financial control: budgetary control and financial analysis.

THE BUDGET

As part of the planning process, management allocates financial resources to different departments of the organisation in order to enable them to accomplish certain goals. By allocating funds to specific activities, management can implement certain strategic plans. This allocation of financial resources is done by means of the budget. From the point of view of control, management wants to know how the financial resources are applied. The budget is therefore used as an instrument of control.

A budget is a formal plan expressed in financial terms that indicates how resources are to be allocated to different activities, departments or sub-departments of an organisation. At the same time, it forms the basis for controlling the financial resources, a process known as budgetary control. Budgets are usually expressed in financial magnitudes, but can also be expressed in other units such as sales volumes, units of production or even time. It is precisely because of the quantitative nature of budgets that they provide the foundation for control systems. They provide benchmarks or standards for measuring performance and making comparisons between departments, levels and periods. More specifically, a budget makes the following contributions to financial control:

Applying the concept W. Edwards Deming, founder of the quality movement

Deming is well known for the 'Red Bead Experiment' that he often used at his four-day seminars. In this experiment, ten volunteers are recruited to work in an 'organisation': six willing workers, two inspectors, an inspector of the inspectors and one recorder. Deming pours 3 000 white beads and 750 red beads into a box, where they are mixed together. Each worker scoops beads out of the box with a scoop that holds 50 beads. Each full scoop is considered to be a day's production. White beads are acceptable; red beads are defects. Workers are asked to scoop out only white beads and no red beads.

Of course, owing to the laws of statistical variability, each worker scoops out some red beads, regardless of how motivated the worker is to get only white beads, how much the 'manager' (Deming) exhorts them not to or how much he praises workers who have fewer-than-average red beads. Deming's message is simple: from a statistical point of view, it is foolish for a manager to use data about the number of red beads any particular worker produces as information for promoting or demoting workers. Rather, statistically speaking, management should acknowledge the following truths:

1. There will always be variation in any process or system.
2. As a result, there will always be variation in the performance of workers (some will perform well, and others will perform less well).
3. It is up to management to improve the system, not to reward and control the individuals within the system.

Many organisations have enjoyed improved performance when implementing control systems that are consistent with Deming's principles. For example, the Ford Motor Company found that transmissions manufactured according to these principles resulted in warranty repairs decreasing tenfold, and that 'things-gone-wrong' customer reports dropped by 50 per cent over a period of five years.

Source: Dyck, B. & Neubert, M.J. 2010. *Principles of management*. International Student Edition. Mason, OH: South-Western Cengage Learning, p. 140.

- It supports management in co-ordinating resources, departments and projects.
- It provides guidelines on the application of the organisation's resources.
- It defines or sets standards that are vital to the control process.
- It makes the evaluation of resource allocation, departments or units possible.

Various kinds of budgets, some examples of which are provided in Table 10.1, can be used to make financial control possible across the financial spectrum.

Table 10.1: Types of budgets

Type of budget	Focus	Examples
Financial budgets	•Cash flow •Capital expenditure	•Cash-flow bud •Capital budget
Operational budgets	•Revenue •The operational aspects of the organisation	•Sales budgets budgets
Non-financial budgets	•Diverse aspects of the organisation that are not expressed in financial terms	•Production bu •Sales volumes •Time projectio

Budgets were traditionally developed in a top-down fashion, where top management would develop the budget and impose it on the rest of the organisation. However, the way budgets are set today, especially in larger organisations, is to involve all managers of operating units, from the bottom to the top, in the budget process. A great deal of interaction takes place between heads of operating units (supervisory management), dimensional heads (middle management) and top management. The budget is usually set by a budget committee consisting of top managers. It is here that members of top management implement their strategies, which they do by allocating financial resources to the areas or divisions that must lead the organisation's strategy.

Budgets have a number of strengths, as well as weaknesses. The most important advantage of a budget is that it facilitates effective control by placing a money value on operations, enabling managers to pinpoint problems. Budgets also facilitate co-ordination between departments and maintain records of organisational performance. On the negative side, however, budgets may sometimes limit flexibility.

Budgets are not the only instrument that management uses to apply financial control. To complement the budget, management can use **financial analysis**, also known as **ratio analysis**, to apply financial control. This will be discussed in Chapter 14.

10.4.1.3 The control of information resources

All the functions of management (planning, organising, leading and controlling) are dependent on supporting information in order to function effectively. However, it is the relevant and timely information that is made available to management during the management process that is vital for monitoring how well the goals are accomplished. Accurate and timely information allows management to implement plans and determine on a continuous basis whether everything is proceeding according to plan, and whether adjustments need to be made. The faster management receives feedback on what is going smoothly or badly in the course of the management process, the more effectively the organisation's control systems function.

10.4.1.4 The control of human resources

Although the control task of management focuses mainly on financial and physical resources, this does not mean that the performance of one of the organisation's main resources – people – is exempt from control. A few remarks will be sufficient to emphasise the scope of control of human resources throughout the organisation.

The main instrument used to control an organisation's human resources is performance measurement.

This entails evaluating employees and managers in the performance of the organisation. More specifically, from a control point of view, the performance of individuals and groups is assessed and compared with predetermined standards. Tasks are subdivided into components. The importance of each subtask is determined so that

criteria and measuring instruments can be developed. Performance standards must then be developed – for example, 40 production units per hour, an accuracy level of 98 per cent in tuning machines, or a quality level of at least 93 per cent. Actual performance can be measured against these standards for feedback to, and action by, management.

Other human-resources control instruments include **specific ratio analyses** that can be applied in respect of labour turnover, absenteeism and the composition of the labour force.

The preceding discussion of the control of an organisation's resources mainly emphasises the formal control systems developed by management. As far as informal control systems are concerned, however, people in the organisation play a decisive role in social-control mechanisms. This refers specifically to group behaviour. When a group of people work together on a regular basis, they develop norms that lay down guidelines for the behaviour of the group. These norms, which may include the quality of products, speed of production and reliability, are usually not written down and have nothing to do with the formal organisational structure. Nevertheless, they have a profound influence on the behaviour of groups when it comes to control or social control. Members of the group subject themselves to the norms of the group because, if they do not, they may be punished by the group in ways that range from light-hearted teasing to outright rejection. Compensation by the group for group cohesiveness and control consists of approval of action, emotional support and the assignment of a leadership role to the leader of the group.

The above discussion of the areas of control provides an overview of the control process as it applies to the organisation's different resources and of some of the instruments that enable management to control resources.

10.5 Characteristics of an effective control system

The following are characteristics of an effective control system:

- Integration;
- Flexibility;
- Accuracy;
- Timeliness; and
- Simplicity.

These characteristics are discussed in more detail below.

10.5.1 Integration

A control system is more effective when it is integrated with planning, and when it is flexible, accurate, objective, timely and simple. The interface between control and planning is discussed in the introduction to this chapter. Control complements planning because deviations highlight the need to review plans and even goals. In this way, control provides valuable inputs to planning. The closer the links between control and planning, the better the eventual control system will be. This is why provision should be made at the planning stage to make control possible, for example, by formulating goals in such a manner that they can be converted into, or applied as, control standards. This means setting quantifiable goals. Figure 10.3 shows how planning and control should be integrated.

Figure 10.3: Integration of planning and control

10.5.2 Flexibility

The second characteristic of an effective control system is flexibility. This means that the system should be able to accommodate change. Timeous adjustments in objectives or plans should not be regarded as deviations, but as revised objectives or plans. The control system should be able to adjust to such revisions, within limits, without management having to develop and implement an expensive new control system.

10.5.3 Accuracy

A control system should be designed in such a way that it provides an objective and accurate picture of the situation. Errors or deviations should not be concealed in the data. A total amount expressed in rands certainly does not show a profit, nor does it indicate which products sell better than others. Similarly, production management can conceal indirect costs to make production performance look good. Inaccurate information leads to incorrect modifications of new plans based on unreliable control data.

10.5.4 Timeliness

Timely control data are not obtained by means of hasty, makeshift measurement. Control data should be supplied regularly, as needed. A sensible approach is one that is based on the principle of timeliness.

10.5.5 Simplicity

Unnecessarily complex control systems are often an obstacle because they can have a negative influence on the sound judgement of competent managers. If managers are hampered by red tape, they may leave the system to keep things going. In so doing, they may lose their personal involvement and motivation to see to it that things proceed according to plan. Unnecessary control is equally demotivating for personnel and leads to resistance to control systems. Too much information, especially if it is irrelevant, makes great demands on the time and attention of management, which means that the control process becomes too expensive. The unwritten rule of effective control is that control should not become so complex that the implementation of the control system becomes more expensive than the benefits derived from it. At the same time, a system should not be oversimplified to the extent that the essence of control is lost.

10.6 Summary

Control is one of the four fundamental management functions. It is the final step in the management process, and the starting point for planning and strategic development. The control process narrows the gap between planned performance and actual performance by setting performance standards in the right places. The performance of management, employees and resources can be measured against these standards and deviations can be rectified if necessary. Control focuses on virtually every activity or group of activities in the organisation, but normally aims at physical, financial, information and human resources. Effective control systems are characterised by the

extent to which planning and control are integrated, as well as the flexibility, accuracy and timeliness of the system. Management information plays an important role here.

However, too much information, especially irrelevant information, demands too much time and attention from management, which makes it too expensive. This ties in with the unwritten rule pertaining to control: the application of the control system should not become so complex that it costs more than it saves. At the same time, the system should not be oversimplified to the point of losing its significance.

This discussion of control as the final fundamental element of management completes the examination of the management process, and with it, Part 2 of this book. It should be clearly understood, however, that the general principles forming the subject of this section are also relevant in Part 3, which deals with the specialised or functional areas of management. Less detail from this section is provided when discussing, say, financial planning or marketing control, where the emphasis in the treatment of different business functions falls mainly on the activities peculiar to a particular functional area.

Small business perspective

Success is well understood in areas such as sport, music and academic achievements. Success is often defined as the achievement of realistic goals. Thus, if a person sets out to achieve a specific goal, and then attains this goal, he or she is perceived to be successful. Failure happens when goals are not achieved.

The control process of a small business will be no different from the control process of a medium-sized or large business. Although the steps followed in the control process will be the same, the application of these steps in a small business will be different. In what follows, we examine the steps in the control process of the small business.

Step 1: Set goals and standards against which the actual performance of the small business can be measured. Generally, standards and goals for the entrepreneurial venture can be classified into personal, financial and strategic goals. Personal goals refer to the initial motivation for starting the new business, such as a need to survive, the drive to develop new products and/ or services, or the need to be financially independent. Financial goals differ widely between different small business ventures. A micro business or spaza shop may have survival as its only financial goal, whereas a small business may be able to generate regular and sustainable profits over a period of time. Lastly, the strategic goals of a small business pertain to its long-term survival within a constantly changing environment.

Step 2: Measure the actual performance of the small business. This step involves the measurement of the personal, financial and strategic performance of the small business. All businesses, including small businesses, aspire to perform well in all three areas.

Step 3: Evaluate any deviations that might occur between set standards and actual performance of the small business. Should the small business perform well in terms of its personal, financial and strategic goals, shareholders will be satisfied with their investment. Should there be any deviations between actual and planned performance and underperformance is detected, steps need to be taken to rectify the deviations. Usually signs of underperformance in a small business are decreasing financial performance (such as decreasing gross and net profit margins), cash-flow problems and negative cash flows for long periods of time, which may lead to failure and a total loss of control.

Step 4: Take steps to rectify deviations. Underperformance can be addressed in various ways. First, the entrepreneur needs to investigate the relationship between the selling price, cost, sales volume, and fixed and variable costs associated with the product and/or service. Furthermore, the entrepreneur should determine whether the business is viable and economically sound. Attention should be directed to improving the cash flow, sales volume and market share of the small business. Confidence in the venture and the entrepreneur is crucial for handling underperformance. When confidence is lost, it is very difficult to rectify. The small business may experience resignations from core staff, and

external stakeholders may want to take their funds out to reinvest them in safer options. Turning an ailing small business around and putting it back on track is a difficult task. The principles for turning an underperforming small business around revolve around the following: management focus; careful financial management practices and principles; a focus on the core business of the venture; formulating and implementing a real turnaround strategy; and speed.

KEY TERMS	
accuracy	economic-ordering quantity
actual performance	flexibility
budget	integration
control	inventory
control by exception	just-in-time system (JIT)
control of financial resources	materials requirements planning
control of human resources	quality control
control of physical resources	simplicity
corrective action	standards
deviation	timeliness

Questions for discussion

Reread the case study on page 292 and answer the following questions:

1. What steps did Tom Boardman take to turn Nedbank around?
2. Identify the key areas of control in Nedbank.
3. How did the control process implemented by Tom Boardman provide feedback for the revision of planning?
4. Explain the characteristics of an effective control system.

Multiple-choice questions

1. Which statement is false?
    a. Control helps organisations to cope with environmental change.
    b. Control systems increase costs in an organisation.
    c. Control helps an organisation to cope with increasing organisational size and complexity.
    d. Control helps to limit the accumulation of error.

2.Financial budgets focus on __________, whereas operational budgets focus on __________.

a.revenue, capital expenditure
b.sales volume, time projection of projects
c.cash flow, revenue
d.capital expenditure, cash flow

3.An effective control system is:

a.integrated with planning.
b.able to accommodate change.
c.objective.
d.all of the above.

4.Control systems for __________ involve usage procedures, periodic inspections and stocktaking.

a.human resources
b.physical resources
c.information sources
d.financial resources

5.Evaluating deviations is step _____ in the control process.

a.one
b.two
c.three
d.four

CHAPTER 11

Operations management

Louis Krüger and Rigard Steenkamp

The purpose of this chapter

This chapter provides a broad overview of important aspects covered in the sub-discipline of operations management. It considers the nature of operations management and provides some definitions of related concepts, and it depicts an operations-management model and discusses each of its components individually. The chapter also classifies different process types for manufacturers and service providers. It then focuses on the three main activities of operations management: operations design, operations planning and control, and operations improvement. Selected tools, techniques and methods that can be used in performing these activities are also introduced.

Learning outcomes

On completion of this chapter you should be able to:

- explain why operations management is important for a business
- define what operations management encompasses
- identify and explain the components of an operations-management model
- distinguish between the six general operations-management performance objectives and explain what each entails
- explain how systems for classifying process types in manufacturing and services may assist operations managers
- identify the aspects involved in operations design
- explain how these aspects need to be managed in order to develop an effective design for products and services, including the processes for their manufacture or delivery
- identify the aspects involved in operations planning and control
- explain how these aspects need to be managed to manufacture or deliver products and services efficiently
- identify the aspects involved in operations improvement
- explain how these aspects need to be managed in order to provide a more effective and efficient operation for the manufacture of products and the delivery of services for competitive advantage.

11.1 Introduction

A business transforms inputs from the environment into outputs to the environment. The **operations function** is that function of the business aimed at executing the transformation process. The operations function and the management thereof (operations management) are therefore directly concerned with creating products and providing services in order to realise the objectives of the business.

11.1.1 The importance of operations management

An effective and efficient operation can give a business four types of advantages:[1]

1. It can **reduce the costs** of making the products or offering the services. (As profit equals revenue minus costs, reducing the costs of production by being more

efficient and having less waste, rework, scrap, spillage and so on will directly contribute towards the profitability of production.)

2.It can **increase the revenue** the business receives for offering its products and services to its customers/clients. (According to the profit equation given above, increasing sales through superior-quality products and service excellence, or just by offering ‘good value for money,’ again directly contributes towards the profitability of a business.)

3.It can **reduce the amount of investment** (capital) needed to manufacture the type and quantity of products or to offer the service required. (Increasing the effective capacity of the operation by better use of facilities, machines or equipment, and seeking new ways and procedures to optimise the functioning of the operation, may decrease the amount of capital required for investment in the acquisition and running of these facilities, machines or equipment.)

4.It can **provide the impetus for new innovation** by using its solid base of operational skills and knowledge to develop new products and services. This can involve manufacturing’s production capability or the offering of new products and services in accordance with international best standards and practices.

Other reasons that operations management is considered important to a business include the following:

- Operations management can improve productivity. Productivity, measured as the ratio of output to input, is a yardstick for the efficacy with which operations management transforms (or converts) the resources of a business into products or services. If a business produces more error-free outputs with less wastage of material inputs, or puts its manufacturing staff to better use, its overall productivity will improve. Higher productivity, in turn, is directly related to increased profitability for businesses, which benefits the country in which the business operates.
- Operations management can help a business to satisfy the needs of its customers/clients more effectively. The customer/client is an important focal point in operations management, and the operations manager should see to it that quality products or services are provided for the consumer at a reasonable price. Satisfied customers/clients are of crucial importance to any business since its long-term survival or existence is dependent on them. Businesses will endeavour, by means of their particular operations skills, to satisfy the needs of their customers/clients more effectively than their competitors do.
- Operations management can be decisive for the general reputation of the business. Some businesses have, through their particular operations skills, built up outstanding reputations as far as high-quality products or services, low costs, or simply ‘good value for money’ are concerned. The operations skills of a business make (and also break) such reputations. Businesses such as Woolworths and Panasonic have built up exceptionally good reputations for high quality and, for such businesses, quality is a competitive advantage that can be used to protect and further expand their market position.

Critical thinking

The importance of operations management

While an effective and efficient operation can give a business several types of advantages, how important is operations management really? Is it more important than marketing, finance and other management functions?

Some people argue that nothing is possible without a good idea, while others say that without money, nothing is possible. Some see operations management as a dynamic and creative discipline: if human beings are seen as the rulers of creation, then operations management brings humans as close as they can be to the act of creation and creating value.

Business life is primarily concerned with creating products and services, putting operations management at the heart of its existence. All managers directly and indirectly create products or services, be they through micro- or macro-processes, for internal or external customers. In this sense, all managers can be viewed as operations managers. Every manufactured thing people see around them, sit on, eat, read, wear, buy and enjoy comes to them courtesy of operations managers who planned and controlled the production system involved.

11.1.2 Defining terms used in operations management

There are many definitions of **operations management**. A common characteristic of all these definitions is that operations management is concerned with the management of the transformation process (the operations process) whereby products are manufactured, or services rendered. To clarify further what is meant by operations management, the following concepts are defined:[2]

- The operations function is that function in the business primarily aimed at the utilisation of resources to manufacture products or render services.
- Operations managers are the personnel in the business who are directly responsible for managing the operations function.
- Operations management (the operations-management function) involves operations managers' activities, decisions and responsibilities that tie in with the execution of the operations function. The operations-management process includes operations planning, operations organising, operations scheduling and operations control.

CASE STUDY: Noise clipper: A solution for noise in manufacturing

Noise Clipper (Pty) Ltd was awarded the AHI Business of the Year award after successfully responding to a global noise control problem. The South African company is situated between the Innovation Hub and the CSIR in Pretoria. Noise pollution is a major global issue and more workers are exposed to potentially dangerous noise levels today than to similar levels of any other noxious agent. Factories and mining operations are noisy environments, and environmentalists and governments take finding solutions for noise pollution and the resultant noise-induced hearing loss (NIHL) very seriously. NIHL compensation statistics are extremely high, and the insidious nature of NIHL makes it a deceptively dangerous 'silent disease'.

The noise problem

A great deal of progress has been made in noise control, yet it seems the challenge remains. Busy factories easily generate harmful noise above 85dBs. The social environment has also changed in terms of a demand for noise. Exposure to social noise has increased in recent decades due to high exposure levels to discotheque music, rock concerts and music from personal music players. Attempts to regulate certain mobile music devices are being investigated by the Belgian government.

A number of pharmaceutical companies (and venture capital investors) continue to pursue drug therapy in their search for developing an oral capsule for NIHL. The military is also seeking a drug that will prevent hearing loss if taken just before noise exposure, or for

treatment after exposure. The mining of minerals has always been an arduous task and is very much still a ‘pick and shovel proposition’. Noise has become a generic hazard common to commodities but to a greater extent to mining operations. The highest noise exposure (from 100 dBs and above) from plant and equipment is associated with loaders, long-wall shearers, chain conveyors, fans and pneumatic percussion tools. Unfortunately, workplace injuries, illnesses and fatalities still occur worldwide, causing immeasurable pain and suffering to employees and their families.

Addressing the problem

OHS (occupational health and safety) is therefore crucial in terms of a multidisciplinary function involving the social, mental and physical well-being of employees. It endeavours to protect all employees, family members, customers, suppliers, communities and other members of the public affected by the workplace environment. The challenge to create and sustain a healthy and safe workplace is increasing in terms of a culture shift towards the human element, philosophy of work and productivity by means of a sound OHS culture.

Responding to the market

Innovation is the planned action of bringing about new ideas, methods, products and services. The terms associated with innovation are ‘re-creation’, ‘adaptation’, ‘imitation’ and ‘invention’. Some regard innovation as the DNA of the modern organisation. Innovation has no recipe and is a complex concept that is difficult to define. The idea is to innovate or stagnate, which implies creativity and change. Noise Clipper strategically positioned itself to design and develop their own products and process technologies (machines) to assist their manufacturing and service delivery processes. Their forms of innovation can be categorised into the degree of novelty or the scope of innovation leading to categories such as incremental innovations, modular innovations and radical innovations.

In-field research by audiologists revealed the need for a hearing protection device (HPD) that is not a one-size-fits-all. Noise Clipper researched the weaknesses of conventional products, and they used several benchmarks of high quality products from Europe. This assisted them in conceptualising a product for the local market. The idea was to design and patent a high quality HPD for African conditions that is more appropriate and cost-effective than current European products (such as Variphone). This implies a custom-made HPD with several unique quality dimensions. The first of these dimensions is a HPD that is personalised and tailor-made for attenuation, comfort and pride. These dimensions will increase user-friendliness and wearability. To achieve this, the Noise Clipper includes the following characteristics:

- Physically sized for comfort, with consistent (low variability) tailor-made sizing.
- The elimination of leakages as verified by a seal-test (measured) and correct fitment.
- Attenuation must be adjusted for the individual’s specific circumstances and working zone. Overprotection is minimised to optimise communication (speech discrimination) and the detection of machines and warning signals. An HPD must accommodate communication while protecting against noise because signal detection, signal localisation and speech discrimination (speech intelligibility) are crucial aspects of fitness for duty and productivity.
- Adjustable attenuation by means of filter mechanisms of which the calibration setting is both fiddle- and tamper-proof (not adjustable to eliminate re-calibration and additional servicing costs). The filter is not calibrated at the premises of the client.
- The Noise Clipper is made in different colours (chosen by the worker) with each user’s name imbedded in the product.
- It is cost-effective solution because of durability; the average price of R400 is compared to the estimated R3000 of conventional products (calculated at a cost of R4 per day times 250 annual working days for a three year period).

The HPD is a catalyst for a hearing conservation programme (HCP)

A huge effort is required to provide effective hearing conservation programmes (HCP). Several mining operations have started outsourcing this service and Noise Clipper has recognised the potential in diversifying by providing a professional HCP service to complement its product. They benchmarked against a 'best practice' programme awarded by the European Agency for Safety and Health at Work (EU-OSHA). The programme is based on four dimensions, and the model has been adopted (and adapted) in many mining operations in South Africa and other manufacturers worldwide. The primary dimensions of this programme are: (1) corporate social responsibility (CSR) and top management (shareholder) support, (2) coaching based on personal risk profiles for curative care and prevention, (3) otoacoustic emissions (OAE) to proactively determine the status of the cochlea and the condition of the ear, and (4) custom-made HPDs.

Noise Clipper is therefore a good example of servitisation in terms of the importance of both the product package and the service package. The product quality is dependent on the quality of the initial service (gaining personal information and the impression made by the field workers), the transformation process (of the acrylic HPD product; assembled, calibrated and packed) and the final service operation (dispatch, scheduling of the fitment and seal test process). Servitisation is a good strategy because it opens doors for product/service diversification and product/service differentiation.

The operations system

The characteristics of the Noise Clipper operations system are:

- To be responsive and flexible when the market demands bigger batch sizes. This is done through project management and adjustable capacity strategies (detailed planning and scheduling of the service operations for the fitment of large quantities based on the predetermined mining shifts). In such cases the scope of the job allows Noise Clipper to manage contracts as small projects and adapt to a resource-to-order operation.
- Innovation, creativity and additional value creation by its own employees. The design and development of the 'Sealometer' (to do seal tests) and the 'Calometer' (to calibrate filters) are examples of process technologies originating from Noise Clipper staff.
- Marketing through high service quality (reliability, responsiveness, and so forth). More orders are generated due to the effective and professional services delivered by the field workers at the plants.
- A typical batch operation with a process layout to produce small quantities per day. The operation is labour intensive because of the custom-made process. Capacity can fairly easily be adapted to meet demand.
- Elimination of waste, small batch sizes and the use of the JIT philosophy for lean manufacturing.
- Short lead times are the norm, although they are a make-to-order business.

Source: Personal interviews with the management of Noise Clipper namely the CEO, Mr Albert Lotter, Persequor Park, Pretoria, 2018. Reprinted by permission of Mr Albert Lotter.

11.2 An operations-management model

Figure 11.1. shows an **operations-management model**[3] that illustrates the management of the operations function. The most notable elements of this operations-management model are the operations-management strategies and objectives, and the management activities that influence the transformation process that produces outputs.

11.2.1 Operations-management strategies and performance objectives

All businesses formulate business objectives, and if a business intends surviving in the long term, consumers who are satisfied with the business's products or services should be a top-priority objective. The operations-management function should take cognisance of customers'/clients' needs and continually formulate its management strategies and objectives in such a way that the competitive position and customer/client base not only remain intact, but, where necessary, are also strengthened and expanded.

Figure 11.1: A general model of operations management

Source: Adapted from Slack, N., Chambers, S. & Johnston, R. 2004. *Operations management*. Fourth edition. Harlow: Financial Times Prentice Hall, Figure 1.1, p. 5. Reprinted by permission of Pearson Business.

Although **customer/client needs** are numerous, they can be reduced to six main elements:[4]

1. Higher **quality**
2. Lower **costs**
3. Shorter **lead time** (quicker manufacturing or provision of services)
4. Greater adaptability **(flexibility)**
5. Lower variability with regard to specifications **(reliability)**
6. High level of **service** (better overall service).

With these six customer/client requirements as a basis, operations-management performance objectives can be formulated to give the business an operations-based advantage over other businesses. Managing operations for competitive advantage or as a 'competitive weapon' is an imperative for modern businesses in the face of increased global competition, rapid technological change, and the higher visibility and importance of ethical business practices, workforce-diversity issues and environmental-protection concerns.

Operations-management performance objectives must therefore indicate the specific areas within the domain of the operations function that will be emphasised when products and/or services are produced or provided.

The operations-management performance objectives are formulated in such a way that they are applicable to both manufacturers and service providers. To acquire operations-based advantages, the following six general operations-management performance objectives (which incorporate the above-mentioned customer/client needs) can be followed:

1. **Do things right the first time**. This means that the operations function should not make mistakes. By providing error-free products and services that are ready and suitable for consumption by customers/clients, the business will gain a quality advantage. Higher quality not only means increased error-free outputs resulting in lower costs, but also an improved competitive position, which could lead to higher prices and a greater market share. Think again of Woolworths' food products in this regard. This business is certainly one of the best known for providing top-quality food products, for which some consumers are prepared to pay higher prices.

2.**Do things cost effectively**. It is imperative that products and services be produced or provided at a cost that will enable the business to place them on the market at a price that will ensure an acceptable profit for the business. This also applies to non-profit organisations because taxpayers and funders insist on good value, which they will receive only if institutions function cost effectively. Hence, when the operations-management function operates cost effectively, it can provide the business with a cost advantage. However, when this does not happen – for example, in the case of a gold mine where the cost per metric ton of mined gold-bearing ore is too high to run the mine profitably – drastic cost-saving measures, such as the large-scale retrenchment of miners, are necessary. In the case of PetroSA, for example, where the high procurement cost of gas and oil made the project uneconomical, the state had to subsidise the project continuously at the expense of the taxpayer.
3.**Do things quickly**. This means that the period of time that elapses between the demand for a product or service and the delivery thereof should be as short as possible. Put differently, the lead time should be shortened. This will increase the availability of the products and services and will give the business a speed advantage. Businesses that do not place their products and services on the market quickly enough will not only have to accept lost sales initially, but will, later on, also have to overcome strong competition from established brands. Think, for example, of a paving construction business that promises to have a new driveway paved in three weeks, but then takes seven weeks to complete the job. Would you recommend this business to your friends? Businesses such as Boss Paving, which is reputed to complete paving faster than its competitors, acquire a speed advantage from which they will later build up a sound reputation in the market.
4.**Make changes quickly**. The operations-management function should be able to adapt or change activities if unforeseen circumstances make it necessary to do so. This applies, for example, when more customers/clients demand a product or service, or if a customer/client requires the delivery of a wider variety of products or services within the agreed time. If the operations-management function can change activities in this way to satisfy customer/client demands both quickly and adequately, the business will have an adaptability advantage. During the 2010 FIFA World Soccer Cup held in South Africa, businesses reacted quickly to the sharp increase in overseas visitors, and car rental companies such as Avis, for example, were able to cope with the sudden increased demand for rental cars. Businesses such as Toyota and Ford, in turn, are known for their ability to adapt their product line quickly to changing customer needs, as in the case of the Toyota Aygo and the Ford Fiesta, both of which met the need for a more economical car.
5.**Do things right every time**. Error-free products and services that satisfy set specifications should regularly and continuously be provided to customers/clients. This gives the business a high-reliability or low-variability advantage. This guideline ties in with the customer/client requirement of high quality. However, it emphasises the ability of the business to meet specifications continuously in the long term. This is of particular importance to businesses that produce or provide products or services on a continuous (or mass) basis. Take the example of McDonald’s Big Mac hamburgers. McDonald’s is an international business that claims that a Big Mac will taste the same in any place in the world where business is conducted. Thus, when people buy their second Big Mac, they will know exactly what they are getting. South African Airways (SAA) also strives for low variability

in respect of times of scheduled departures to various destinations. If SAA's flights over a period of a year, for example, depart on schedule and reach their destinations 85 per cent of the time, one could therefore say that the airline renders a more reliable service compared to other domestic carriers like Mango (78 per cent), Kulula (74 per cent) and S.A. Express (72 per cent).[5]

6. **Do things better**. With due regard to all the preceding operations-management guidelines, a business will also endeavour to provide a better total product or service package compared to that of its competitors. This gives the business a service advantage. Think of businesses such as M-Net and BMW, which have gained reputations because they stand out above their rivals as far as service is concerned. This guideline is closely intertwined with the concept of total quality management (TQM), which is, today, the focal point of many top businesses internationally. TQM's point of departure is that quality products or services cannot be produced or provided unless the whole business (all of the different functional-management areas) works together to achieve this goal. TQM will be discussed in more detail in Section 11.6.3.

Figure 11.2 illustrates the positive results that can be obtained by each of the above-mentioned operations-management performance guidelines.

Figure 11.2: Positive results obtained by the application of operations-management guidelines

Source: Adapted from Slack, N., Brandon-Jones, A. & Johnston, R. 2013. Operations management. Harlow: Pearson Education Limited. Table 4.1, p. 99. Reprinted by permission of Pearson Education Limited.

11.2.2 The transformation model

The operations function is primarily concerned with using resources (inputs) to provide outputs by means of a transformation process. Therefore, the **transformation model** comprises three main components: inputs, the transformation process itself and outputs.

A basic transformation model (also referred to as an input-transformation-output model) is depicted in Figure 11.3. This model can apply to both manufacturers and service providers.

11.2.2.1 Inputs

Inputs used in the transformation process comprise both the resources that are to be transformed (processed, changed or converted) and the resources required to make the transformation possible.

The resources to be transformed include the following:

- **Material**. A wide variety of material, both processed and unprocessed, can be used as inputs in the transformation process. For example, a motor manufacturer will use mainly processed material such as steel, glass and plastic, while a gold mine will use primarily unprocessed material (gold ore). For a service provider such as a hairdresser, different hair products, for example, shampoo and tinting agents, represent the material inputs.

- **Customers/clients**. Clients can serve as the inputs in the transformation process when the client is the subject being transformed or 'processed'. For example, the client who receives dental treatment is the primary input in the transformation process. The same applies to recreational facilities such as gymnasiums and recreational events such as rock concerts because the client is the most important input who is transformed through being exercised or entertained.
- **Information**. Information can either be the primary input that is transformed, as when information is processed into news for a newspaper, or it can be used as the secondary input in a transformation process, as when information about consumer preferences regarding vehicle colours is used when a vehicle is processed.

Figure 11.3: A basic transformation model

Source: Adapted from Knod, E.M & Schonberger, R.J. 2001. *Operations management: Meeting customer's demands*. Seventh edition. (International Edition). McGraw-Hill Higher Education. Adaptation of Exhibit 1-4 on Page 12a. Reproduced with permission of The McGraw-Hill Companies through Copyright Clearance Center.

The resources required to make transformation possible include the following:

- **Human resources**. In most transformation processes, some or other form of human involvement is necessary. This includes both workers who are physically involved in the transformation process and the people involved in a supervisory capacity. Some manufacturing processes are more labour intensive than others. A gold mine, for example, is more labour intensive than a motor-vehicle manufacturing plant, where many of the processes have been automated. Service providers such as hotels are normally also labour intensive, and the service sector is therefore seen as the sector with the most potential for job creation.
- **Equipment and facilities**. Equipment and facilities can assume many different forms. For example, manufacturers use factories, machinery and equipment; hospitals use wards, examination rooms and operating theatres; banks use offices, computers and telephones; restaurants use eating areas, tables, chairs, grills, serving counters and take-away counters; universities use lecture halls, laboratories, theatres and sports fields; and supermarkets use shopping areas, storage rooms, display areas, shelves, aisles and cash registers.
- **Technology**. The role of technology as an input in the transformation process is becoming increasingly important. Technology is generally used to enable the transformation process to function more efficiently. Thus, new knowledge and techniques (automation) can help a manufacturer to manufacture better products of higher quality more quickly. Service providers can also apply technology (for example, satellite communication) to render better services more quickly.

11.2.2.2 The transformation process

The **transformation process** converts inputs into outputs. The nature of the process is determined by which type of input is predominantly being processed.

When materials are transformed, the transformation process is primarily geared towards changing their physical characteristics (shape or composition). Most manufacturers, such as motor-vehicle or furniture manufacturers, employ such transformation processes. Service providers that also fall into this category include

those that involve materials changing location (a delivery business), changing ownership (wholesalers and retailers) or primarily being stored (warehouses).

When information is transformed, the primary input is being processed. This occurs when information changes in composition or shape (for example, an auditor's report), changes ownership (for example, a market-research publication), is disseminated and changes location (for example, telecommunication) or is merely stored (for example, a library).

When customers/clients are transformed, this may also occur in a variety of ways. Some processes change the physical characteristics of clients (for example, hairdressing), while others change their physiological condition (for example, medical treatments at hospitals) or emotional condition (for example, entertainment at cinemas).

The location of clients can also be changed (for example, by airlines) or they can merely be 'stored' or accommodated (for example, in hotels).

11.2.2.3 Outputs

The ultimate goal of any transformation process is to transform inputs into outputs. **Outputs** assume the form of products or services. Manufacturers normally produce certain products (for example, motor vehicles or furniture), while service providers render certain services (for example, haircuts or transport).

The characteristics of products and services differ in ways that have specific implications for the management of the various operations processes.

The important differences between products and services need to be clearly understood through a comparison of the two; that of the products of the manufacturer and services provided by the service provider. The manufacturer's product exists physically, is long-lasting, and the output is held as stock, whereas a service is intangible, perishable, and the output is not held as stock. The manufacturer has very little customer contact, whereas the service provider is heavily involved with customers. A product is manufactured before use, whilst the provision and consumption of a service is simultaneous. There is a long response time for manufacturing, and a short response time for service delivery. Local and international market opportunities may be considered by the manufacturer, whereas a service is usually provided in local markets. The manufacturer often needs large production facilities, involving capital- and labour-intensive production, whereas the service provider generally needs less working space, but may be more labour intensive. Quality measurement is fairly straightforward to measure in manufacturing, but can be difficult to measure in service delivery.[6]

The differences listed above represent two extreme positions on a continuum between pure product manufacturers and pure service providers. In practice, however, businesses are, to a greater or lesser degree, involved in both the manufacture of products and the provision of services.

The transformation process, which comprises three main components of inputs, the transformation process and outputs, has already been explained. Table 11.1 provides examples of the inputs, the nature of the transformation process and the outputs of a variety of businesses.

Table 11.1: Inputs, transformation processes and outputs of various businesses

11.2.2.4 Different operations have different characteristics

While the basic purpose of all operations is similar in that they transform inputs into outputs, the processes may differ fundamentally in four ways (the four Vs):[7]

1. The **volume of output** may differ. This refers to the number of items produced by the operation over a given period of time. The more of one type of product that is made, the greater the benefit that may be obtained through standardisation and repeatability of the tasks and procedures. The most important implication of this characteristic with regard to the operational process is its influence over the cost of making a product or delivering a service: a lower production cost per unit is possible as fixed costs are spread over a larger number of units. The volume of output may range from high (for example, 220 motor vehicles per day) to low (for example, 20 aeroplanes per year).
2. The **variety of output** may differ. This refers to the range of different items produced by the operation over a given period of time. The more types of products made by the same operation, the greater its flexibility and ability to provide non-standardised products or services – though these will inevitably come at the price of a higher cost per unit of manufacture or delivery. The most important implication of this characteristic with regard to the operational process is its capability of matching its products and services to the exact needs of customers/clients. Variety of output may range from high (for example, a taxi service to and from any location in and around Johannesburg) to low (for example, a fixed route and time schedule for a metropolitan bus service).
3. The **variation of output** may differ. This refers to the particular demand pattern for the output of the operation, which may be constant or may be highly irregular, non-routine and unpredictable. The most important implication of this characteristic with regard to the operational process is the possibility of a sudden and dramatic change in the operations capacity required to supply products and services in order to meet the needs of customers/clients. Operations likely to experience seasonal variations (for example, hotel resorts in coastal locations) must be able to deal with marked variation in demand levels, from full occupancy during peak season to underutilisation for the remainder of the year. Other hotels located in city centres may have constant patronage from business guests during most of the week and utilise special tariffs over weekends to level the demand. In the latter case, the unit costs will be lower than those of a comparable hotel with a highly variable demand pattern.
4. The **visibility of output** may differ. This refers to how much of the operation's activities the customers/clients experience themselves or are exposed to. In high-visibility operations, the customers/clients experience most of the value-adding activities first-hand or directly, for example, in a designer's wedding-dress shop. This type of operation must be able to deal with a short waiting tolerance compared to low- or zero-visibility operations, with which the customer/client does not have much contact, as in the case of a larger departmental clothes store, or no contact at all, as in the case of a catalogue clothing retailer.

The implications of these four Vs of operations can be quite significant in terms of the cost of creating the products and services. While high-volume, low-variety, low-variation and low-visibility operational processes keep processing costs down, low-

volume, high-variety, high-variation and high-visibility operational processes generally have a ‘cost penalty’ (as explored in the box that follows).

Two service providers with very different models

The University of Pretoria (UP) is the largest contact residential university in South Africa’s tertiary education sector, with more than 53 000 residential (undergraduate and postgraduate) students.[8] The University of South Africa (Unisa) is the largest open distance learning (ODL) (non-residential university), with about 351 000 students.[9]

For UP, the tuition cost and fees per student will be markedly higher than in the case of Unisa because of on-campus class attendance with lecturers for all courses, limits on class sizes, and other more customised learning assistance found in laboratories and practical class sessions. However, Unisa offers distance education with hard-copy study materials with no or limited lecturer contact. It accepts students from across South Africa and even worldwide. Unisa can therefore offer a quality tertiary-education package to students far afield at much lower tuition fees per student.

UP is good at what it does through its particular tuition model. Unisa, similarly, has been exceptionally good for more than 145 years since 1873 at non-contact distance education, and should not try to emulate residential universities in offering high-cost customised tuition activities, since, inherently, its operational processes are not designed for these and cannot be modified superficially for such a different tuition model.

A manufacturer versus a service provider

A motor-car manufacturer produces products that are physically tangible (the vehicle itself), durable (not used up in one period) and can be kept in stock (when more vehicles are manufactured than the number demanded immediately). There is no customer contact while the vehicle is being manufactured and, unless there are already a few vehicles in stock, it may take a while to deliver the vehicle to the customer. Motor-car manufacturers usually have large production facilities and expensive equipment, which make this a capital-intensive industry. Because of the tangible nature of vehicles, it is possible to set, monitor and ensure objective standards as far as quality is concerned.

A dentist renders a professional service. The service itself is intangible (it cannot be held or touched) and can also not be kept in stock if it is not used immediately. The presence of the user of the service (the patient) is necessary while the service is being rendered and the response time is usually short. Provision of the service takes place in a small service facility (a dental surgery), the service itself is labour intensive (the dentist is involved) and, because the service is intangible, it is more difficult to set and maintain objective standards.

11.3 The classification of process types for manufacturers and service providers

Section 11.2 described an operations-management model that is applicable to both manufacturers and service providers, yet the exact nature of the transformation processes does differ. Such differences are important when the management of a particular operation is considered because certain management techniques and methods are suitable for application only in certain types of operation. Therefore, it is useful to classify the process types that manufacturers and service providers use.

11.3.1 The classification of process types for manufacturers

In manufacturing, the most common **classification system** classifies different operations processes according to the **volume of output** (scope) and the **variety of products**. Thus, a business that produces a product in large volumes with little variety (for example, a manufacturer of bricks) will be placed in a different category from a

business that manufactures small volumes of a large variety of products (for example, a clothing manufacturer). According to such a classification system (see Figure 11.4), five main categories are identified. Each is discussed below with the aid of practical examples:[9]

1. **Project processes**. Projects represent operational processes that are highly individual and unique, but that are normally tackled on a large scale. It can take a project team months or even years to complete such projects. Examples are construction projects (such as the building or upgrading of an airport, bridge, highway or shopping complex), the development programme for a new car or the upgrading of an assembly line. Each project produces an output volume of one (the volume is therefore low), but a wide variety of project types can be undertaken (variety is therefore high). Two such large projects, which have recently been completed (or are near completion) in South Africa, are the construction of the Medupi (4 764MW) and Kusile (4 800MW) coal-fired power stations as well as the Gautrain (a high-speed commuter railway line between Johannesburg, Midrand and Pretoria).
2. **Jobbing processes**. Jobbing normally represents operational processes conducted on a small scale with a low volume of output. The nature of the work is the same throughout, but the specific requirements differ from one task to the next. Examples are the process whereby a goldsmith manufactures jewellery (each piece of jewellery is usually unique and takes the unique design preferences of the client into consideration) and the printing of wedding invitations at a printing works (two wedding invitations for two different couples are usually not exactly the same in all respects). Thus, an important feature of these types of processes is that they combine a wide variety of products with a small volume of products.
3. **Batch processes (job lots)**. In batch production (lot production), a limited range of products is manufactured by the business and production occurs in batches (or lots). Batch production appears to be nearly the same as jobbing, but it does not have the same degree of variety. Examples of batch production are the manufacture of domestic appliances such as toasters, grills, irons and fridges by Defy, or the manufacture of televisions, DVD players and sound equipment by Samsung.

Figure 11.4: The classification of manufacturers' operational processes

Source: Adapted from Slack, N., Brandon-Jones, A. & Johnston, R. 2013. Operations management. Harlow: Pearson Education Limited. Figure 4.3. p. 102. Reprinted by permission of Pearson Education Limited.

4. **Mass processes.** Mass production is a well-known term for the production of products in high volumes, but with relatively little variety. While there may be some variants of the product itself (for example, the colour, engine size and installation of optional equipment offered by motor-car manufacturers), the basic process of production is the same, repetitive in nature, largely predictable and easier to manage than both jobbing and batch processes.
5. **Continuous processes**. Continuous production is a step beyond mass production because the volumes are even greater, but there is very little variety in the type of product. Such processes provide the same product on a continuous basis without a

break, other than the occasional need for maintenance or plant upgrading. Examples are a wheat mill (Sasko), an electricity generation utility (Eskom), a cement manufacturer (PPC cement), a petrochemical refinery (Sasol) and a paper manufacturer (Sappi).

11.3.2 The classification of process types for service providers

The same classification criteria used for manufacturers can be used for service providers (one based on output volume and output variety). According to such a classification system (see Figure 11.5), three main categories can be identified. Each is discussed below with the aid of practical examples:[11]

Figure 11.5: The classification of service providers' operational processes

Source: Adapted from Slack, N., Brandon-Jones, A. & Johnston, R. 2013. Operations management. Harlow: Pearson Education Limited. Figure 4.3, p. 102. Reprinted by permission of Pearson Education Limited.

1. **Professional services.** Professional services represent operational processes provided on a high client-contact basis, where the client is usually present within the service process for a considerable period of time. Contact often occurs on a one-to-one basis. The nature of the service provided takes the specific needs of clients into consideration and is therefore more people oriented than equipment oriented. Because of the client-focused nature of these services, the extent (volume) of presentation is low, while the variety of services that can be provided is high. Examples of professional services (referred to as such because of the formal academic qualifications and registration that such professional practitioners need to obtain) include the services of dentists, doctors, attorneys, auditors and management consultants.
2. **Service shops.** Service shops represent operational processes where the characteristics of service provision fall between those of professional services and those of mass services. There is a fair amount of client contact and services are standardised to a certain extent, but the services are also adapted to accommodate the unique needs of clients (there is more variety than there is in mass services). The number of clients served is also greater (the volume processed is usually more than with professional services). Examples of service shops are banks, hotels and retail stores.
3. **Mass services.** Mass services represent operational processes where many client transactions take place with limited client contact and in which the nature of the services provided is largely standardised (variety is therefore low). These services are usually equipment oriented and are provided on a larger scale (volume is therefore high). Examples of mass services include post and telecommunication services, air- and rail-transport services, and television-broadcast services.

11.4 Operations design

11.4.1 The nature of operations design

The design of a product – for example, a motor car – entails far more than merely determining its physical appearance in terms of shape, colour and finish. It also includes the design of the operational processes for manufacturing the different components of the motor car, such as the body assembly, paintwork and composition of the chassis and engine. Similarly, in the design of a service – for example, a 24-hour security monitoring and reaction service – the processes (or systems) should be designed to execute the particular service as specified. This may involve an alarm system, a control room, security personnel and reaction vehicles.

Thus it is clear that **operations design** entails two interdependent aspects:

1. The design of products and services (also referred to as product design)
2. The design of operations product or service processes to manufacture or provide these products or services (also referred to as process design).

The primary aim of operations design is to provide products and/or services and processes that satisfy the needs of customers/clients in the best possible way.

Figure 11.6 provides a broad framework of the different activities involved in operations design.

Design, as an operations activity, helps to achieve the operations-management objectives with regard to quality, cost, lead time, adaptability, variability and service. The designers of a product such as a fridge, for example, will endeavour to design an aesthetically acceptable product that will satisfy customers' expectations regarding functionality and reliability, as well as be quick and easy to manufacture. The design should also be such that errors in the manufacturing process are kept to a minimum so that manufacturing costs can be kept at a reasonable level.

Designers of services (for example, a cellphone or Internet service) are also expected to construct the service in such a way that clients' expectations are met, and the service can be rendered affordably and within the operational ability of the business. Most, if not all, products and services encountered in the market today first have their origin as a vague idea or concept put forward as a suitable solution to a perceived need of a customer/client. The idea or concept is refined over a period of time and, in the process, more and more detailed information is attached to the idea or concept. Ultimately, there is sufficient information to put together a specification for the product or service, and the process for its manufacture or provision.

Figure 11.6: The nature of operations design

Source: Slack, N., Chambers, S. & Johnston, R. 2004. *Operations management*. Fourth edition. Essex: Pearson, Figure 4.1, p. 95. Reprinted by permission of Pearson Business.

11.4.2 The design of products and services

Although the operations manager is usually not solely and directly responsible for the design of a product or service, he or she is indirectly responsible for providing the information and advice on which the ultimate success of the development, manufacturing or delivery of the product or service depends.

11.4.2.1 The competitive advantage of good design

The design of a product or service begins and ends with the customer/client. Initially, products and services are designed with a view to satisfying the needs of the

customer/client in the best possible way. If products or services are well designed, produced and provided so that the expectations of customers/clients are realised or even exceeded, the business's competitive position will be reinforced through the increased sales of these products and services. For example, the design and production of the well-known Venter trailer is a good example of how a competitive advantage can be gained in the market. Other manufacturers have since entered the market with similar products, but Venter is still the market leader.

11.4.2.2 The components of products and services

All products and services consist of three interdependent components:[12] a concept, a package and a process. The concept (or idea) is the set of expected benefits that the customer/client purchases when purchasing a product or service in response to his or her needs. Because customers/clients are not just buying the product or service, but also this set of expected benefits, the product or service should meet all their expectations. For example, when someone buys a new car, not only the car itself is bought, but also all the expected benefits that go with it, such as safety, reliability, outstanding road-holding ability and, possibly, a high value at resale. The same applies when a service – for example, medical treatment at a hospital – is purchased. The patient expects a set of benefits such as good medical care, the timeous receipt of prescribed medication, and a secure and peaceful environment so that he or she can recover from the illness.

The set of expected benefits that a customer has is referred to as the 'product concept', while the set of expected benefits that the client has is referred to as the 'service concept'. When the product or service is designed, the operations manager should understand exactly what the customer/client expects from the business. This knowledge and insight is of vital importance to ensure that the transformation process provides the 'right' product or service concept.

Concepts involve a **package** of products and services. The concept of a product usually refers to a tangible physical object such as a car, dishwasher or article of clothing, while the concept of a service indicates an intangible object such as a visit to a theatre, a hairdressing salon or a nightclub. However, as mentioned above, it is often difficult to make a clear distinction between these two concepts. Take, for example, a new car. The physical vehicle is clearly a tangible object, but the other benefits – such as the guarantee and the regular repairs at scheduled times – are an intangible service. A meal in a restaurant comprises physical products such as food and drink, but also service in that the food is prepared and served, and even the atmosphere in the restaurant plays a role. Thus, regardless of whether it is a product or service that has been designed, the package comprises a combination or 'bundle' of products and services. It is this package that the customer/client in fact purchases.

Two further aspects should be kept in mind in the composition of a service package:

1. Services cannot be inventoried. For example, if an appointment or flight ticket is not used, then the opportunity 'lapses' and is wasted.
2. Services usually involve direct interaction between the customer/client and the process.[13] They can involve high contact (seeing a psychotherapist) or low contact (posting a letter).

A **process** is necessary to create the package of products and services. The design of the products or services takes place in conjunction with the design of the processes required to manufacture or provide them. (The stages of the design of products and services are discussed in Section 11.4.2.3, and the design of the processes is discussed in Section 11.4.3.)

11.4.2.3 The stages in the design of products and services

The design of a product or service ultimately results in a **full detailed specification** of the product or service. To compile this specification, detailed information must be obtained about the concept (the form, function, aim and benefits of the design), the package (the composition of products and services required to support the concept) and the process of creating the package (which determines the way in which the individual products and services of the package will be manufactured or provided).

To obtain this full detailed specification, it is necessary to first follow certain consecutive steps. Although not all businesses necessarily follow the same steps, the typical sequence of steps is as follows:

- **Concept generation**. The first step in designing a product or service starts when different ideas for new product concepts or service concepts are generated. New ideas for products or services can come from within the business itself (for example, the ideas of personnel or those from formal research and development programmes) or from outside the business (for example, the ideas of customers/clients or competitors).
- **The screening process**. Not all concepts that are generated will necessarily develop into new products and services. Concepts are evaluated by means of a screening process based on certain design criteria, such as feasibility (how difficult is it and what investment is needed?), acceptability (how worthwhile is it and which return is possible?) and vulnerability (what could go wrong and what risks are there?). Each of the stages that follows progressively refines the original concept up to the point where there is sufficient information and clarity for it to be turned into an actual product or service with an operational process to produce or deliver it. Such progressive reduction of the multitude of design options for a new product and service occurs through a process of elimination that is referred to as the 'design funnel'.[14] Overall, the purpose is to determine whether the new concept will make a significant contribution to the product or service range of the business. Several functional management areas – such as marketing, operations and finance – are involved in the screening process of new concepts, and each may use different criteria in this process. The operations manager is responsible for operations-focused screening to determine whether the business has both the ability (people, skills and technology) and the capacity to produce or provide the concepts.
- **Preliminary design**. Once the ideas and the concepts generated by the particular functional-management areas in the business are reduced to one or two potentially acceptable product or service concepts, the next step is the preliminary design of the product or service. The preliminary design is the first attempt to specify the composition of the components of the product or service to be included in the package and to identify the processes that will be necessary to produce or provide the product or service package.
- **Evaluation and improvement**. The aim of this step is to evaluate the preliminary design with a view to improving it, and making the process of manufacture and provision less expensive and easier. Various techniques and methods can be used as aids in this step.
- **Prototype and final design**. The last step in the design of products or services is the development of a prototype of the product, or a simulation of the service, in order to test it in the market. If the prototype, which is based on the improved preliminary design, is favourably received in the market, the final design and specifications of the product or service can be compiled.

11.4.3 The design of operations processes

The design of operations processes to manufacture products or provide services is just as important as the design of the products or services themselves. Without both competent product design and competent process design, it is impossible to develop, manufacture or provide a successful product or service.

11.4.3.1 The design of supply networks

No operations process exists in isolation; it is always part of a greater, integrated **supply network.**[15] Besides the specific operations process itself, the supply network also includes the suppliers of materials or services, as well as intermediaries and final customers/clients.

In the design of a particular operations process, it is important for the entire supply network to be taken into consideration. This enables the operations manager to determine precisely what the inputs for the specific operations process are and the customer/client needs that have to be satisfied.

Such a study also helps the business to determine its competitive position in the supply network, identify significant interfaces in the supply network and reflect on its long-term involvement in the supply network.

11.4.3.2 The layout and flow of manufacturing and service-provision facilities

The **layout** of the operations facility determines the physical arrangement of the resources (such as machines, equipment and personnel) used in a particular transformation process. The layout of a manufacturing or service-provision facility is usually the first characteristic of an operational process to be observed because it determines the physical form and appearance of the facility. At the same time, the layout determines the way in which resources such as materials, information and customers/clients **flow** through the transformation process. Both the layout and flow of an operations facility are of particular importance since small changes in the placement of machines and the flow of material and people can greatly influence the operational process in terms of cost and efficiency.

The layout of a manufacturing or service-provision facility entails three steps: selecting the process type, selecting the basic layout type and making a detailed design of the layout.

The first step is **selecting the process type**. The different process types for both manufacturers and service providers were discussed in Section 11.3. The process types for manufacturers are project, jobbing, batch, mass and continuous processes. For service providers, they are professional services, mass services and service shops.

The second step is **selecting the basic layout type**. Four basic layout types,[16] that depict the general form and arrangement of operations facilities, can be identified (see the box on page 334). The four basic layout types are as follows:

1. **The fixed-position layout**. In this layout, the product cannot be shifted on account of its size, shape or location. The resources for transformation (equipment, machinery and people) are taken to the receiver of the processing, which is static, for example, a construction site or a shipyard.
2. **The process layout (flexible-flow layout)**. In this layout, similar processes (operations) are grouped together into sections. For example, if a business manufactures not only basic office chairs, but also tables and desks, these can be grouped together for the tasks (sawing, planing, turning and attaching).

3. **The product layout (line-flow layout)**. In this layout, the different processes (operations) required to manufacture a product or provide a service are arranged in consecutive order. Thus the layout is adapted to the product, as in the case of an assembly line for motor vehicles or the service counters in a self-service cafeteria.
4. **The cellular layout (hybrid layout)**. In this layout, specific processes are placed in a cell, which is then arranged according to either a process or a product layout. A good example here is a department store selling men's, ladies' and children's clothing. The men's department functions as an independent cell with its own layout, and the same applies to the ladies' and children's departments.

However, the selection of a basic layout type merely provides an indication of the broad layout of the operations facility. It does not determine the precise placement of the various machines and equipment. The final step in the layout of a manufacturing or service facility therefore entails making a **detailed design** of the layout.

11.4.3.3 The application of process technology

All operations processes use some or other form of process technology. Process technology refers to the machines, equipment and apparatus used in the transformation process to transform materials, information and clients so that products can be manufactured or services provided. Process technology may range from relatively simple processes (for example, a basic extraction process such as using a machine to dig a hole for a new pipeline) to highly complex and sophisticated systems (such as automated manufacturing, which uses robots). Automated manufacturing represents the future of 'overall better' manufacturing and service provision. This will involve less human involvement and greater use of robotics to develop the 'ultimate machine' that will be able to deliver extraordinarily high levels of error-free products and services (quality), nearly instantaneously (speed), whenever required (dependability), inexpensively (cost) and with much-reduced waste and greater efficiency.[17]

The operations manager has to be involved continuously in the management of all facets of process technology. To perform this task effectively, he or she needs to:

- foresee how technology can improve a specific operational process;
- decide which technology or technologies to use;
- integrate the new technology with existing operations activities;
- continually monitor the performance of the technology; and
- upgrade or replace the technology when necessary.

Although the operations manager is not necessarily a specialist in each technological field, he or she should still have an understanding of what a particular technology essentially entails and how the technology performs the particular function. He or she should also be able to identify the advantages and limitations of a particular technology in the operational process.

For example, a cotton farmer will have to decide whether to mechanise the harvesting process by using a cotton harvester or whether to continue using manual labour. The advantages of mechanising the operational process would be likely to include the speed at which the cotton is harvested, the better quality of the collected cotton and cost savings over time. Limitations would possibly include greater capital expense and greater process complexity.

11.4.3.4 Job design and work organisation

Operations management focuses not only on the technologies, systems, procedures and facilities in a business (the so-called non-human component), but also on people's involvement in the operations activity itself. The way in which human resources are

managed in a business has a fundamental effect on the effectiveness of the operations function. Since most people who are appointed in a business are usually active in the operations function, this places a huge responsibility on the shoulders of the operations manager as far as leadership in the business and development of employees are concerned. **Job design** is of vital importance in operations management because it determines how workers perform their various daily tasks. Work study is a scientific approach that can be used to great effect in job design and **work organisation**. It refers to the application of different techniques to study all the factors influencing the people in the work environment systematically in order to improve the execution of tasks in terms of efficiency and effectiveness. Two work-study techniques often encountered in the literature are method study and work measurement.[18] **Method study** entails the systematic recording and critical investigation of present and proposed work methods, with a view to the development and application of easier and more effective methods in an effort to reduce costs. **Work measurement** entails the application of techniques designed to determine how long it takes a trained and qualified worker to do a specific job at a fixed level of performance. The components of work study are illustrated diagrammatically in Figure 11.7.

Applying the concept Four basic layout types

Fixed-position layout

Process layout or flexible-flow layout

Product layout or line-flow layout

Cellular layout or hybrid layout

Figure 11.7: Components of work study

Source: Slack, N., Chambers, S. & Johnston, R. 2007. *Operations management*. Fifth edition. Essex: Pearson, p. 261, Figure 9.5. Reprinted by permission of Pearson Education, Inc., New York, New York.

11.5 Operations planning and control

11.5.1 The nature of operations planning and control

In Section 11.4, design was examined as one of the activities of operations management. This design activity determines the physical form and structure of the operations process, and it has to be activated within the limits imposed by the design of the

operations process. This is done by means of operations planning and control. Operations planning and control focuses on all the activities required to put the operations process into action efficiently on a continuous basis so that products can be manufactured or services can be provided to meet the needs of customers/clients.

In contrast to operations design, which may be regarded as a 'passive' activity primarily aimed at determining the broad limits of the operational process, operations planning and control is an activating activity that starts the operational process 'physically' so that products can be manufactured or services can be rendered. In the activation of the operational process, the operations manager is responsible for ensuring that the operations-management performance objectives of quality, cost, lead time, adaptability, variability and service (see Section 11.2.1) are pursued and achieved.

Critical thinking

Some true South African innovations

Which products and/or services were originally developed in South Africa?

New products and services are important for the emergence of new businesses. Consider, for example, the development of cellphone technology, also known as mobiles. Some new businesses (for example, Nokia) came into being as manufacturers of cellphones, although other existing businesses (for example, Sony, Motorola and Samsung) merely expanded their product ranges. In South Africa, no service providers existed at the time when cellphones first made their appearance, but some new businesses were subsequently started (for example, Vodacom, MTN and later Cell C).

Not only can new products and services be seen as catalysts for the emergence of new businesses, but they can also be considered as vital for the continued success of other businesses. Some countries (such as the United States and Germany) are known for regularly offering new product ideas or new technologies and innovations, while others (such as Japan and China) are said to prefer, in the main, to copy others or apply technology already discovered. Some innovative new products and services are accredited to South Africans. The following ideas for products or services received recognition from the Cape Town Science Centre as the top ten inventions or discoveries by South Africans:

1. Dolosse. These concrete blocks, shaped like interlocking bones, are used on breakwaters to withstand wave action. First used in East London and later around the world, they were invented by harbour engineer Eric Merrifield and his team.
2. Kreepy Krauly. This automatic pool-cleaning device was originally a South African invention, but it is now owned by an American company. Other pool-cleaning devices that originated from South Africa include brand names such as Aquanaut, Baracuda and Pool Ranger.
3. Tellurometer. This pioneering distance-measuring device was invented by Trevor Wadley.
4. Pratley Putty. This is a two-part clay-like mixture that bonds into a very hard and strong compound. It is the only South African invention to have gone to the moon. It was invented by K.G.M. Pratley.
5. Lunar stick. This is the oldest mathematical artefact in the world (35 000 years old), and was found in a cave in northern Kwazulu-Natal.
6. Scheffel bogey. This revolutionary train-carriage wheel assembly is used in Austria and South Africa.
7. Disa telephone. This was the first push-button telephone in the world. It was invented by Telkom technicians.
8. Appletiser and Grapetiser. These sparkling drinks use a pure fruit-juice recipe.
9. Computicket. This was the first computerised ticket-sales system in the world.
10. Vibol fuel-saving exhaust system. This is used all over the world.

Source: Editors Inc. 2006. *South Africa at a glance 2005–2006*. Greenside: Editors Inc., pp. 268–269. Reprinted by permission of Editors Inc.

Operations planning and control activities broadly endeavour to reconcile two entities. On the supply side, there are the products manufactured or services provided in the operational process. On the demand side, there are the specific needs of actual and potential customers/clients for products or services. Planning and control activities are aimed at reconciling the provision ability of the operations facility with the demand for specific products or services. Figure 11.8 illustrates the nature of operations planning and control in this process of reconciliation.

Figure 11.8: The nature of operations planning and control

Source: Adapted from Slack, N., Chambers, S. & Johnston, R. 2004. *Operations management*. Fourth edition. Essex: Pearson, Figure 10.1, p. 323. Reprinted by permission of Pearson Business.

Reconciling the supply of products or services with the demand for them by means of planning and control activities occurs in terms of three dimensions:

1. Volume (the quantity of products or services)
2. Timing (when the products or services have to be manufactured or provided)
3. Quality (whether products or services consistently conform to customers'/clients' expectations).

To reconcile the volume and timing dimensions with each other, three different but integrated activities are performed: the loading of tasks, the sequencing of tasks and the scheduling of tasks.[19]

The **loading of tasks** refers to the volume or quantity of work allocated to a particular work centre. The available capacity of the operations process needs to be taken into consideration in the loading of work centres. For example, a medical practitioner will examine only one patient at a time in his or her consulting rooms, while the other patients wait in the waiting room.

The **sequencing of tasks** refers to the sequence in which the tasks are performed. The sequence in which tasks are performed can be determined beforehand by the use of certain priority rules, such as dealing with the job with the earliest deadline first, or following a first-in, first-out approach. A commercial bank, for example, will serve the client who is at the front of the queue first.

The **scheduling of tasks** refers to the use of a detailed roster that indicates when a specific task should start and when it should be completed. Gantt charts are especially popular for planning and scheduling projects, and also give an indication of which tasks are late and which tasks are at a more advanced stage than anticipated.

After having viewed operations planning and control from a general perspective, the focus moves to specific operations activities: capacity, inventory and supply chain, and quality.

11.5.2 Capacity planning and control

The focus of capacity planning and control is on the provision of the manufacturing or service capacity of a particular operations process. When a suitable balance is found between the available capacity and the expected demand, it is possible that the business will have both satisfied customers/clients and acceptable profits. However, if the

balance is 'wrong' – that is, too much capacity with too little demand, or too little capacity with too much demand – the business is faced with a potentially disastrous situation. Businesses in this position may sit either with costly surplus capacity or with possible lost sales opportunities. Because of the far-reaching impact that capacity decisions may have on the business as a whole, capacity planning and control are of vital importance in operations management.

11.5.2.1 Defining capacity

The term '**capacity**', as it is used in everyday language, usually refers to the fixed volume of, for example, a fuel tank (50 litres) or the space, for example, in a parking garage (bays for 500 vehicles). However, from an operations point of view, these scale or size dimensions are not sufficient, since capacity also has a time dimension (as illustrated in the box below).

Applying the concept Calculation of the total capacity of a parking garage

If there are 500 parking bays in a parking garage at a supermarket, 500 vehicles can park there at a given time. However, this is not the total capacity. If the parking garage and supermarket are open for ten hours a day and customers take, on average, an hour to do their shopping, the total capacity of the parking garage is actually 5 000 motor vehicles (number of parking bays × number of hours for which the parking garage is open average time for which a car is parked).

In an operations process, capacity is defined as 'the maximum level of value-added activity over a period of time that the process can achieve under normal operating circumstances'.[20]

11.5.2.2 The nature of capacity planning and control

While long-term capacity is already determined during the design of the operations process in the medium and short terms, there is the possibility of adapting or varying the capacity of the operations process in accordance with changes in the demand for particular products or services. Thus, particular machinery or equipment can be used for longer periods each day, or workers can be asked to work overtime during peak periods.

Operations managers generally have to work with a demand forecast that is by no means completely accurate and, moreover, is sometimes subject to regular fluctuation. **Quantitative data** on the expected demand and the **required capacity** to satisfy this expected demand must be obtained by applying the three steps described below.

Step 1: The total demand and required capacity must be determined. As a rule, the marketing function is responsible for determining the total demand by means of demand forecasting. Since this forecasting is an important input in determining the required capacity, the operations manager must at least have some knowledge of the basis for and rationale behind the demand forecasts. The way in which the required capacity will be determined depends on the nature of the products manufactured or services provided. With standardised products and services (where there is high volume with little variety), capacity will be measured in terms of output (for example, the number of television sets to be produced per week or the number of flights to be provided to Cape Town each day). In the case of less standardised products and services (where there is lower volume and more variety), capacity will instead be measured in

terms of input. (Examples here are the number of working hours per week of a goldsmith making items of jewellery or the number of beds available in a hospital per day.)

Step 2: Alternative capacity plans must be identified. The operations manager is expected to have alternative capacity plans in order to accommodate possible changes in demand. Three options are available:[21]

1. A level-capacity plan in which the capacity levels are kept constant and demand fluctuations are ignored.
2. A chase-demand plan in which capacity levels are adjusted according to fluctuations in demand.
3. A demand-management plan in which demand is adjusted to tie in with available capacity.

In practice, operations managers usually use a mixture of the three alternative capacity plans, although one of them may be more dominant than the others.

Step 3: The most suitable approach to capacity planning and control must be chosen. Here, an endeavour is made to choose an approach that will best reflect the business's specific circumstances. For example, a fruit-packing plant will employ more temporary workers during the harvesting season to help with the packing of the fruit.

Applying the concept The moving-average demand-forecasting technique

Table 11.2 shows how the moving-average demand-forecasting technique is applied to forecast the demand for washing machines for May 2019.

Table 11.2: Three-month moving-average demand forecast for washing machines

Based on a three-month moving average, the demand forecast for May 2019 is therefore 550 units of washing machines.

However, the disadvantage of this approach is that if the demand continues to grow, the predicted demand is always going to be too low. In this example, the actual demand may be 610 but, according to the moving average, only 550 washing machines will be manufactured and there will, therefore, be a shortage.

11.5.2.3 Techniques and methods used during capacity planning and control

Various techniques and methods can be applied during capacity planning and control to execute this activity better. Two of these methods are the moving-average demand-forecasting technique and the cumulative representations of demand and capacity. (Other techniques and methods, such as exponential levelling, demand-forecasting accuracy measures and the application of the queuing theory, are regarded as advanced topics and are therefore not included in this text.)

Applying the concept Cumulative representations of demand and capacity

This method can be applied to evaluate a capacity plan for a coal mine. It would appear from the example that the production of coal from a South African mine during the months January to April was greater than the demand for it, and that there was 'surplus' production

during this period. From April to July (autumn and winter), the demand for coal was greater than production – hence there was a period of 'underproduction'.

The **moving-average demand-forecasting technique** is based on the availability of actual demand data over preceding periods. This technique can be used to forecast the demand for the following period and is especially suitable for applying to the demand for products where the demand pattern is stable over the short term.

Cumulative representations of demand and capacity is a method that can be used to evaluate the effect of different capacity plans graphically.

11.5.3 Inventory and supply-chain planning and control

These days, inventory and supply-chain planning and control are regarded as activities executed by a separate functional management area called purchasing management. However, since the inventory of materials and the purchase thereof have significant implications for the smooth functioning of the transformation process, for which the operations manager is mainly responsible, **inventory** is usually defined (from an operations-management perspective) as all stored resources (material, information and clients) required for the smooth functioning of the operations process. The operations manager should therefore liaise closely with the purchasing manager in order to manage inventory levels optimally.

Inventory and purchasing planning and control are discussed in Chapter 15.

11.5.4 Quality planning and control

Nowadays, quality is regarded as being so important in many businesses that responsibility for it is not confined to the operations-management function only. The basic premise of concepts such as total quality management (TQM) is that quality products and services can be manufactured only if the entire business contributes to the achievement of such an objective.

Quality is one of the main methods of adding value to products and services, and thereby obtaining a long-term competitive advantage. Better quality influences both factors that contribute to the business's profitability: income and cost. Income can be increased by more sales and greater market share, while costs can be reduced by lower repair and inspection costs, and reduced wastage, inventory and processing time.

11.5.4.1 Defining quality

Different definitions of quality are often advanced. Each of them stems from a different approach to or view of quality. Thus, '**quality**' has been defined as 'the absolute best', 'something flawless', 'suitable for the purpose for which it was designed', 'meeting a set of measurable characteristics' or 'good value for money'. From an operations-management perspective, quality is defined as 'consistent conformance to customers'/clients' expectations'.[22]

Operations management therefore defines quality in terms of what a customer/client expects of a particular product or service, while the customer/client sees quality in terms of his or her own perception of the product or service. This difference between expected quality (by operations management) and perceived quality

(by customers/clients) is known as the quality gap. Operations management, in conjunction with the other functional management areas, should endeavour to eliminate any quality gaps.

11.5.4.2 The nature of quality planning and control

The aim of quality planning and control is to ensure that the products or services that are manufactured or provided conform to or satisfy design specifications. The discussion of the design of products and services stated that the ultimate goal of this activity is to establish specifications for products or services that will satisfy the needs of customers/clients. Hence, what exists here is a customer/client–marketing–design–operations cycle. This design cycle (see Figure 11.9) can be further extended to include quality planning and control activities to ensure that products or services do in fact meet design specifications.

Figure 11.9: Extending the product/service design cycle for quality planning and control

Source: Slack, N., Chambers, S. & Johnston, R. 2004. *Operations management*. Fourth edition. Essex: Pearson, Figure 17.6, p. 601. Reprinted by permission of Pearson Business.

11.5.4.3 The steps in quality planning and control

Quality planning and control can be divided into six steps.

Step 1: Defining the quality characteristics of the product or service. The design specifications for products or services are determined in the design activity. The design specifications as such are not monitored by quality planning and control, but rather by the operations process that manufactures the products or provides the services. This is to ensure that the specifications are met. For the purposes of **quality planning and control**, it is necessary to define certain quality characteristics that relate directly to the design specifications for products or services. **Quality characteristics** that are often used include:

- functionality (performance ability);
- appearance (aesthetic attractiveness);
- reliability (continuous performance capability);
- durability (total life expectancy);
- serviceability (reparability); and
- contact (convenience of interaction).

Thus, for example, a customer will expect an expensive Blu-ray player to record and replay TV programmes clearly, to be aesthetically pleasing, and to have a long and reliable lifespan and problem-free maintenance and repair.

Step 2: Measuring the quality characteristics of the product or service. For each individual product or service, the quality characteristics should be defined in such a way that they can be **measured and controlled**. The different quality characteristics should thus be further broken down to make such measurement possible. For example, if the quality characteristic of functionality is measured in relation to a motor car, it can be broken down into the measurable dimensions of speed, acceleration, fuel consumption and road-holding ability. However, it is sometimes difficult to measure specific quality characteristics, such as the friendliness and efficiency of service provided by sales staff in a store. Here, an effort will instead be made to gauge shoppers’ perceptions of the

service provided by staff, in order to measure this. Indeed, customers shopping at Woolworths will often receive, by email, a questionnaire rating service in a store they have recently shopped in (Woolworths card holders).

Critical thinking

Good-quality products and/or services

What constitutes a good-quality product or service?

Much attention is paid in the business world to the concept of good-quality products and services. However, some businesses view quality as important, but not necessarily critical for business success, while other businesses stake their reputations on quality and are known for providing their customers/clients with the best possible quality products and services. Think of Woolworths foods and Avis car rentals in this regard.

This leads to the question: Is quality really so important? To help answer this question, it is worth asking another question: Who wants a product that is broken or performs below expectations, or poor service delivery? Undoubtedly, the answer to this is: No one.

If good-quality products and services are considered important for customers and clients alike, it logically follows that businesses that want to be successful over the long term should pay attention to these requirements. Thus better-quality products and services have definite advantages for a business.

Better-quality products and services improve the competitive position of the business by:

- enabling it to sell its products or services at a premium or a higher price in the marketplace; and
- creating the possibility of increasing the business's market share.

Both of these aspects lead to increased revenue for the business through market-route benefits and, in the end, increased profitability.

Better-quality products or services increase the defect-free output of the business by:

- lowering the costs of operations (through reductions in waste, rework, scrap and so on); and
- increasing the level of overall productivity.

Both of these aspects lead to increased revenue for the business through cost-route benefits and once again, in the end, increased profitability.

Clearly, better-quality products and services have the possibility of not only increasing the revenue of the business through the market and cost routes, but, more importantly, they have the possibility of improving its long-term profitability.

To conclude, good- or better-quality products and services are important for customers/clients, and businesses can only profit from improving their total quality initiatives.

Source: Based on an illustration of the benefits of TQM as contained in Schonberger, R.J. & Knod, E.M. (Jr). 1991. *Operations management: Improving customer service*. Fourth edition. Homewood, Illinois: Irwin, p. 139. Reproduced with permission of The McGraw-Hill Companies.

Step 3: Setting **standards** for each quality characteristic of the product or service. Once the operations manager has ascertained which quality characteristics are going to be measured and how, the next step is to set specific quality standards against which the achievement of, and conformance with, the quality characteristic can be measured. Although most businesses strive for 'absolutely perfect' standards (for example, 'the quest for zero defect'), it is generally too expensive or unrealistic to expect a motor vehicle, for example, to last forever. Instead, realistic, achievable standards are set – for example, that the motor vehicle will have an effective lifespan of ten years.

Step 4: Controlling quality against the set standards. Once realistic standards for measuring the output of the operations process have been laid down, the next step is to

determine whether the product or service does, in fact, measure up to them. Three questions in particular are of importance to the operations manager here:

1. Where in the operations process should one check to see if the standards have been satisfied? There are three possible positions: at the beginning of the process (preventive control), during the process (in-time control) or after the process (reactive control).
2. Should each individual product or service provided be checked to determine whether the standards have been met? It is not always possible or desirable to inspect all products or services fully, and managers could instead use samples to determine whether the products or services do in fact meet the standards.
3. How should the inspection be conducted? In practice, most businesses use sampling to ascertain whether their products or services measure up to standards. Two methods used here are statistical process control (SPC), whereby the inspection of a quality characteristic takes place during the process of manufacturing or service rendering, and acceptance sampling (AS), whereby inspection occurs after the process of manufacture or service rendering.

Step 5: Identifying and rectifying the **causes of poor quality**. An important goal in quality planning and control is to identify the presence of poor quality and the reasons for it, and then rectify the poor quality.

Step 6: Continuously improving quality. As was mentioned earlier, quality is one of the most important ways of adding value to products or services in order to obtain a long-term competitive advantage – hence the importance of **improving quality** on a continuous basis. (This aspect will be discussed further in Section 11.6.)

11.6 Operations improvement

11.6.1 The nature of operations improvement

Sections 11.4 and 11.5 examined the design of the operational process, and the planning and control of the operational process. Yet, even if both of these activities are successfully executed, the task of the operations manager is still not complete. Any operational process, regardless of how well it is initially designed or how well it is planned and controlled, can certainly be improved. Nowadays, the **improvement of the operational process** of a business is seen as a further (and probably even more important) activity of the operations manager.

Figure 11.10 provides a broad framework of the various activities that are pertinent in operations improvement.

Figure 11.10: The nature of operations improvement

Source: Adapted from Slack, N., Chambers, S. & Johnston, R. 2004. *Operations management*. Fourth edition. Essex: Pearson, p. 639. Reprinted by permission of Pearson Business.

Before any operations process can be improved, it is necessary to determine what its current performance is. Performance measurement is therefore a prerequisite for any improvement. In measuring performance, managers ascertain the extent to which the present operations process satisfies the formulated operations-management objectives as far as quality, service, adaptability, lead time, cost and variability are concerned.

11.6.1.1 Different types of performance standards

Once managers have determined, by means of performance measurement, the extent to which the present operations process satisfies the set operations-management objectives, the overall performance of the process should be evaluated. This is done by comparing the present performance level with certain standards. Four kinds of **performance standards** are generally used:

1. **Historical performance standards** (by which present performance is compared with the particular business's own performance in previous years).
2. **Target performance standards** (by which present performance is compared with predetermined standards, which indicate an acceptable or reasonable level of performance).
3. **Competitors' performance standards** (by which present performance is compared with that of one or more similar competitors – as in the case of benchmarking, where businesses evaluate their own operations function by comparing their product or service package with that of their competitors).
4. **Absolute performance standards** (by which current performance is compared with the theoretical maximum achievable performance standards).

11.6.1.2 Priorities for improvement

Once the performance of the present operations process has been measured and compared with one or more of the performance standards, the areas that need improvement should be clear. However, not all areas earmarked for improvement are equally important. **Priorities for improvement** therefore need to be determined. This is done by taking into consideration the needs and preferences of customers/clients, and the performance and activities of competitors.

The **needs of customers/clients** provide an indication of those performance areas of particular importance to them. Operations-management objectives should reflect the preferences of clients/customers, such as high quality or low costs. The internal operation or functioning of a specific operations process should be focused on achieving these preferences.

However, the competitors' performance and activities play a different role in establishing priorities for improvement. The performance of the business's operations process in relation to the performance of its so-called competitors enables the business to identify its operations-based advantages.

11.6.1.3 Approaches to improvement

Once the priority areas for improvement have been determined, a specific approach or strategy for improvement must be decided upon. Two divergent **approaches to improvement** can be followed: breakthrough improvement or continuous improvement.

In **breakthrough improvement**, dramatic and large-scale changes occur in the functioning of an operations process, but not very regularly. The major changes in respect of products or services, process technology, or methods of work will, it is hoped, lead to improved performance. Business process re-engineering (BPR) is an example of a radical breakthrough-improvement approach that is encountered in practice today.

In **continuous improvement**, also known as Kaizen improvement, more regular, but smaller, incremental changes take place in the functioning of the operations process. The aim is to improve the process on a continuous basis. The plan–do–check–act (PDCA) cycle is an example of a continuous improvement approach that is used in practice. South African motor manufacturers make frequent use of this approach. Their

staff are, accordingly, strongly encouraged to suggest continuous small changes in the work process. A further continuous improvement approach is the adoption of lean management principles. This focusses on smoothing the work flow through all of the processes, doing simple things well and better each time, meeting customer needs and eliminating all forms of waste in each step of the process.[23] Seven types of waste that the Toyota production system (TPS) seeks to eliminate under its lean philosophy are:[24]

- over-production (producing more than what is immediately required);
- long waiting times (low equipment and labour efficiency);
- transport (moving items around the operation back and forth with double or triple handling);
- process (poor component design of the process and poor maintenance of equipment);
- inventory (the target should be that all inventory is eliminated);
- motion (simplification in the process without unnecessary movement of items); and
- defectives (the total costs of quality defectives must be taken into consideration).

11.6.2 Failure prevention and recovery

Regardless of how well a particular operations process is designed, and thereafter put into operation by means of planning and control, there remains the chance of failures or breakdowns occurring. No operations process is always perfect. However, acceptance of the fact that failures will occur does not mean that such events should be ignored. Some failures may have less serious consequences than others, while other failures may be critical for the functioning of the operations process itself. Hence, a continuous endeavour should be made to limit the occurrence of failures. Operations managers have a particular responsibility to improve the reliability of the operations processes that manufacture products or provide services on a continuous basis.

11.6.2.1 Types of failures

Failures in operations processes may occur for one or more of the following reasons:

- **Design failures** (these occur when the design of the process is found to be wrong or inadequate – for example, when a particular model of Samsung (the Galaxy Note 7) was withdrawn due to a design error which caused a potential fire hazard with the smartphones);[25]
- **Facility failures** (these happen when one or more components of the facility itself, such as machines or equipment, breaks and causes parts of, or the whole facility, to grind to a halt; an example of this failure is the failure resulting from a lightning strike putting all the computers of a service provider out of action);
- **Staff failures** (these happen when mistakes are made or set procedures are not followed – for example, when workers are not properly trained or where job performance comes to a standstill because of strikes);
- **Supplier failures** (these happen when suppliers do not provide products or services according to the agreement – for example, when supermarkets place advertisements for special offers and the suppliers do not deliver the order on time); and
- **Customer/client failures** (these occur when customers/clients use a product or service incorrectly or do not use it for the purpose for which it was designed; an example of this failure is the failure resulting from a customer using a 1 300 cc car to tow a caravan that requires a car engine of at least 3 000 cc for towing).

11.6.2.2 Failure detection and analysis

As failures will unfortunately and inevitably occur, operations managers should have mechanisms in place to detect such failures, and then be able to put procedures into operation to determine the causes of the failures. **Mechanisms to detect failures** include process-monitoring, complaints and feedback questionnaires from customers/clients. In failure analysis, techniques such as cause-effect diagrams and analysis of customer/client complaints are used. Feedback questionnaires from clients are especially important to detect shortcomings in the rendering of services. This is one of the principal reasons why hotels ask their guests to fill in forms on the quality of their service.

11.6.2.3 Systems-reliability improvement

When there is clarity about the causes and consequences of failures, operations managers should endeavour to prevent them in the first place. This will increase the reliability of the entire operations process. This can be done by redesigning the products and services, or the processes that manufacture or provide them, or by implementing regular maintenance and repairs. In the case of failures that still do occur, additional back-up systems or components can be used. It may also be necessary to launch a training or motivation programme for the staff.

11.6.2.4 Recovery of failures

Operations managers attempt to reduce the occurrence of failures and the results thereof by means of failure detection and analysis, and systems-reliability improvement. However, when failures still occur, **recovery procedures and contingency plans** should already have been devised and put in place to minimise the potential detrimental effects on customers/clients.

11.6.3 Total quality management

The concept of total quality management (TQM) appears above in the discussion of the quality-planning and control activities of operations management (Section 11.5.4). It was also stated that these days, the quality of products or services is not regarded as the responsibility of the operations manager alone. The concept of TQM is far wider, hence the entire business is responsible.

11.6.3.1 Defining total quality management

Total quality management (TQM) may be defined as a management philosophy that primarily aims to satisfy the needs and expectations of customers/clients by means of high-quality products or services, and that endeavours to shift the responsibility for quality from the operations-management function to the entire business (that is, all other functional management areas and the employees therein). TQM is further primarily aimed at:[26]

- meeting the needs and expectations of customers/clients;
- covering all parts of the business, regardless of how small or seemingly insignificant they are;
- making each and every employee in the business quality conscious, and holding him or her responsible for his or her contribution to the achievement of TQM;
- identifying and accounting for all costs of quality (both prevention and failure costs);
- doing things right the first time (proactive rather than reactive action);
- developing and implementing systems and procedures for quality and the improvement thereof; and
- establishing a continuous process for improvement.

The concept of TQM did not develop overnight. Many so-called 'quality gurus', such as A. Feigenbaum, W.E. Deming, J.M. Juran, K. Ishikawa, G. Taguchi and P.B. Crosby, contributed to what has today become known as TQM.

According to J.S. Oakland's TQM model (see Figure 11.11), the focal point of total quality is the underlying processes that occur at each customer/client and supplier interface. To this should be added specific hard-management components (quality systems, techniques and methods, and teams) and soft-management (or human) components (commitment, communication and culture).

Figure 11.11: Total quality management model

Source: Republished with permission of Taylor & Francis Informa UK Ltd from Oakland, J.S. 2003. *Total quality management*. Third edition, Oxford : Butterworth-Heinemann, p. 21. Permission conveyed through Copyright Clearance Center, Inc.

11.6.3.2 The ISO/SANS 9001:2015 quality management system

The South African Bureau of Standards (SABS)[27] is considered the leading African standardisation body for the social and economic benefit of South Africa in the global economy for 'achieving higher product quality and integration of the different business functions; overall efficiency in business and promotion of service excellence in the various sectors of the economy; enhance competitiveness among organisations in local and international markets; and support of government imperatives to grow business process services'. It believes the quality management principles around which a quality standard should be developed include 'customer focus, leadership, evidence-based decision-making, relationship management, engagement of people, process approach and improvement.' A standard for quality management that is used throughout the world to lay down the requirements for a quality-management system is the **ISO 9000 series**. This series provides comprehensive recommendations as to how a quality-management system should be compiled for a particular type of business whether it be for manufacturing and/or service businesses.

The ISO 9001:2015 document[28] sets out the requirements under ten headings: scope, normative references, terms and definitions, context of the organisation, leadership, planning, support, operations, performance and improvement. The first three clauses provide the scope and context of the quality management system for the business. The remaining seven clauses are aligned to the well-known PDCA management improvement cycle (Plan, Do, Check and Act) where leadership, within the context of the organisation, planning and support form the basis of the PLAN; the operation - the DO; performance evaluation - the CHECK; and last, improvement - the ACT. Note: the new standard places a lot of emphasis on risk-based thinking whereby formal risk analysis is used to identify and manage the challenges of the business processes.

11.6.3.3 The implementation of total quality management

The way in which TQM is implemented in a business determines how successful this application will be. Factors that should be taken into account are listed below,[29] along with bracketed terms referring to management components of Oakland's TQM model[30] (see Figure 11.11):

- Integration of TQM in the overall business strategy (systems)

- Top management and employees' support and involvement (commitment)
- Teamwork in the improvement initiatives (teams)
- Feedback on quality successes that have, in fact, been achieved (communication)
- Creation of quality awareness (culture)
- Training of employees in quality techniques and methods (techniques/methods).

Oakland revised his model in 2003. In this revised model, he referred to the four Ps (hard components) and three Cs (soft components) of TQM.[31] While the 'soft' components of the earlier model remain the same, the new 'hard' components are processes (systems), people (teamwork) and planning (techniques/methods), which are all linked to performance.

11.7 Summary

This chapter provided a broad overview of the important aspects covered in the sub-discipline of operations management. It examined the nature of operations management and introduced a general model of which all components were discussed in more detail. The classification of different process types for manufacturers (goods or product producers) and service providers was also illustrated.

Thereafter, the chapter examined in more detail three of the activities of operations managers: design, planning and control, and improvement. Operations design is concerned with the design of products or services that will satisfy the needs of customers/clients and the design of operational processes to manufacture or provide them. Once the design activities have been completed, the operations process must be put into action by means of operation planning and control. Specific responsibilities in this regard include capacity planning and control, inventory and purchasing planning and control, and quality planning and control. Once these activities have been executed, the operations manager should consider how to improve the operation. Operations improvement involves both improving the reliability of the entire operations process on a continuous basis by failure prevention and recovery, and improving the entire business by applying the concept of TQM so that quality products or services can be manufactured or provided to satisfy customers'/clients' needs optimally.

Small business perspective

With reference to the case study in the beginning of the chapter, Noise Clipper (Pty) Ltd was awarded the AHI Business of the Year award after the business (a typical SME) successfully responded to a global noise control problem. They entered the OHS (occupational health and safety) market with a bold vision. The small company started with 10 employees in Pretoria, and their vision to address the need for quality hearing protection for thousands of people has worked to their advantage. Although the four owners (the entrepreneurs) commenced very conservatively (without debt), and as part-time employees, they did a few strategically correct things in terms of patent registration, Department of Labour (see footnote, page 412) approval, SABS tests and CSIR tests. As turnover slowly increased they moved to a more professional environment with networking advantages: between the Innovation Hub and the CSIR in Pretoria. They regard operations management as the heart of the organisation, even for their marketing campaign. Innovation is an inherent business value and they believe technology can be developed if it is difficult to obtain. They associate innovation with 're-creation', 'adaptation', 'imitation' and 'invention'. Their belief is to innovate or stagnate, which implies creativity and change.

Noise Clipper strategically positioned itself to design and develop their own products and process technologies (machines) to assist their manufacturing and service delivery processes. They patented their own hearing protection device (HPD), which has a unique tamperproof filter mechanism. After a market development phase lasting a few years, sales

increased when large mining groups started pilot studies (small batch orders for testing). This led to a few breakthroughs, including large orders from platinum mines. As the business grew, Noise Clipper continued their research and extended their product range in collaboration with known international brands. This co-branding strategy was a huge success, and orders from factories and mines grew. Because the product is custom-made it involves a service that can be extended. They offered a servicing contract to maintain (clean, calibrate, recover, etc.) the HPD. This led to developing and subsequently offering the hearing conservation programme (HCP). Noise Clipper could therefore diversify in terms of providing a professional HCP service to complement its product. They benchmarked against a programme awarded 'Best Practice' by the European Agency for Safety and Health at Work (EU-OSHA). The model has been adopted (and adapted) in many mining operations in South Africa and other manufacturers worldwide. Noise Clipper is therefore a good example of servitisation in terms of the importance of both the product package and the service package. It is also a very good example of a South African small business that has become a prominent market leader with international partners.

KEY TERMS	
approaches to improvement	operations design (process desig
batch operation/process	operations improvement
capacity planning and control	operations objectives
competitive advantage of good design	operations planning and control
composition of products and services	operations processes
continuous operation/process	operations strategy
customers/clients	outputs
design of products/services (product or service design)	performance standards
design of supply network	priorities for improvement
failure prevention and recovery	process technology
flexibility	process types
inputs	productivity
inventory and supply chain planning and control	project operation/process
ISO/SANS 9000:2015 quality management system	quality
jobbing operation/process	quality planning and control
job design and work organisation	reliability

layout and flow	stages of products or service des
lead time	Total Quality Management (TQM
mass operation/process	transformation

Questions for discussion

Reread the Noise Clipper case study on page 313 and answer the following five questions:

1.Factories and mining operations are noisy and environmentalists and governments seek solutions for noise pollution and the resultant noise-induced hearing loss (NIHL). Do you agree with the argument that operational noise (above the legal limit) is harmful to productivity (e.g. noise detrimentally affecting demanding tasks) as well as for personal health? Should noise pollution be a major concern worldwide if more workers are being exposed to more potentially dangerous noise levels than to similar levels of any other noxious agent? What is meant by the insidious nature of NIHL?

2.Many operations have a noise challenge. Noise has become a generic hazard common to the extraction of all commodities. The highest noise exposure (from 100 dB and above) comes from plant and equipment, associated with loaders, long-wall shearers, chain conveyors, fans and pneumatic percussion tools. Should management have a different approach, such as a unique HCP, for mine workers?

3.Hearing conservation is a challenging science. A huge effort should be made to obtain an effective HCP. Signal detection, signal localisation and speech discrimination (speech intelligibility) are crucial aspects of fitness for duty and productivity. Which fundamental principles will you apply if you had to describe (or design) an effective HCP?

4.Noise Clipper strategically positioned itself to design and develop its own products and process technologies (machines) to assist its manufacturing and service delivery processes. Which were the specific categories of innovation that the company achieved?

5.The Noise Clipper HPD is personalised and tailor-made for attenuation, comfort and pride. These dimensions are regarded as important for user-friendliness and wearability. List the other product characteristics and relate them to ownership of, and pride in, the product.

Multiple-choice questions

1.An effective and efficient operation can give a business many advantages. Which of the following is not one of these advantages?

a.It can reduce the costs of making the products or offering the services.

b.It can reduce the amount of investment (capital employed) needed to manufacture the type and quantity of products or offer the service required.

c.It can be decisive for the general reputation of the business unless the customer/client is not regarded as the focal point in operations management.

d.It can improve productivity and it can help a business to satisfy the needs of its customers/clients more effectively.

2.For the purposes of quality planning and control, it is necessary to define certain quality characteristics that relate directly to the design specifications for products or services. Which quality characteristic is not often used?

a.Performance ability
bReliability (continuous performance capability)
c.Durability (total life expectancy)
d.Limited customer contact (for the convenience of privacy)

3.Which of the following is not an input in the transformation process?

a.Information
b.Products
c.Technology
d.Customers/Clients

4.What factors need to be taken into account to successfully implement TQM?

i.Top management's and employees' support and involvement (commitment)
ii.Teamwork in the improvement initiatives (teams)
iii.Feedback on quality successes that have, in fact, been achieved (communication)
iv.Creation of quality awareness (culture)
a.i
b.ii,iii
c.ii, iv
d.all of the above

5.__________ failures happen when mistakes are made or set procedures are not followed.

a.Design
b.Facility
c.Supplier
d.Staff

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CHAPTER 12

Human resource management and the South African labour legislative framework

Barney Erasmus

The purpose of this chapter

The purpose of this chapter is to introduce the issues relating to the management of human resources within an organisation, to explain the theories on the motivation of human resources and to provide an overview of the most important labour legislation that has an impact on the workplace.

Learning outcomes

On completion of this chapter you should be able to:

- describe the basic steps involved in human resource planning
- explain how companies use recruiting to find qualified job applicants
- describe the selection techniques and procedures that companies use when deciding which applicants should receive job offers
- describe how to determine training needs and select the appropriate training methods
- discuss how to use performance appraisal to give meaningful performance feedback
- describe basic compensation strategies and how they affect human resource practice
- describe the role of the human resource function in organisations
- explain the contribution human resource management can make to the effectiveness of an organisation
- provide an outline of who is responsible for human resource management
- list and explain the different content theories of motivation
- discuss the process theories of motivation
- evaluate the different motivation strategies
- understand the importance of the Constitution of the Republic of South Africa, 1996
- describe the impact of the following acts on the management of human resources in organisations:
  - »The Labour Relations Act (No. 66 of 1995)
  - »The Basic Conditions of Employment Act (No. 75 of 1997)
  - »The Skills Development Act (No. 97 of 1998)
  - »The Skills Development Levies Act (No. 9 of 1999)
  - »The National Qualifications Act (No. 67 of 2008)
  - »The Employment Equity Act (No. 55 of 1998)
  - »The Occupational Health and Safety Act (No. 85 of 1993)
  - »The Compensation for Occupational Injuries and Diseases Act (No. 130 of 1993)
  - »The Unemployment Insurance Act (No. 63 of 2001).

CASE STUDY: Baden Aniline and Soda Factory (BASF): Setting our sights on the future

The company Badische Anilin- und Soda-Fabrik (German for Baden Aniline and Soda Factory) create chemistry – and have been doing so for more than 150 years. Their portfolio ranges from chemicals, industrial solutions, performance materials, nutrition and care as well as surface technologies to agricultural solutions. As the world's leading chemical company, they combine economic success with environmental protection and social responsibility. Through science and innovation, they enable their customers in every industry to meet the current and future needs of society. They have summed up this contribution in their corporate purpose: 'We create chemistry for a sustainable future'. Every day, their employees work on developing innovative solutions for customers around the world. Their people's passion, imagination, and determination are crucial to their success as a market leader. Although they employ over 114 000 people throughout the company, they dedicate themselves to supporting and empowering each individual in finding the right path to their success.

Best-in-class performers

BASF's employees are fundamental to achieving the goals of their strategy. They focus on three strategic directions: people empowerment, differentiated approach for better decision-making and inclusive leadership. Career development, life-long learning, the support and development of their leaders as well as the inclusion of diversity are cornerstones of their human resource management.

Employee development and learning

At BASF, they want their employees to make the most of their talents and their job – and they offer many ways to do that including a global framework for development of all employees. They provide employees with interesting and challenging learning opportunities. BASF is a well-known talent developer worldwide because of the broad range of challenging assignments, trainings, career patterns, and the opportunity for cross-organisational moves.

Employee development

Every BASF employee is expected and invited to actively shape their own development. To support this, they offer a structured process and tools via their Employee Development approach. When they support their employees in reaching their potential and aspirations, it helps the company build a modern, high-performing and customer-centric organisation, and encourages all BASF employees to find creative solutions for our customers.

Lifelong learning

BASF provides a multitude of learning opportunities, from classroom-based to learning on the job. For employees, lifelong learning means development not just for now but also for the future. Their various learning offers enable employees to optimise performance and realise their potential in every stage of their career.

Diversity

In order to address the various demands of their customers and markets, BASF relies on their diverse and agile teams in all areas and functions around the globe. The inclusion of diversity is an important component of their strategic human resources management. It helps the company to continuously improve their teams' performance, power of innovation, and increases creativity, motivation and identification with the company. For BASF, Diversity + Inclusion is one of the essential keys to business success and the well-being of their staff. Embracing and cherishing the unique strengths of Diversity + Inclusion means creating an environment that gets the best out of every employee.

To make this a reality, BASF:

- promotes an inclusive culture, which accepts and enhances the diversity in people, experience and capabilities.
- embraces talents and abilities of all kinds both inside and outside the company, to foster growth and the power to innovate in every part of the business.

Diversity and inclusion in practice

BASF has a number of measures in place to establish diversity and inclusion worldwide. Management plays a key role in this. For example, Diversity+Inclusion training programmes have been developed and introduced for senior managers in every region.

Promoting diversity for many years

BASF has been promoting diversity and inclusion for many years. Embracing diversity has become an increasingly important aspect of their strategic HR management in every region. ‘Embrace diversity’ has also been defined as a personal competency worldwide since 2010. BASF thereby underlines the importance of valuing the inclusion of diversity, which forms part of the staff selection process as well as of the career development of all employees. This importance is also reflected in the BASF corporate values, especially in the value of ‘openness’.

BASF in Africa

The BASF Group has been active in Africa for close to 90 years. Four country clusters have been identified, namely, headquarters in Midrand, South Africa for Southern Africa; Nairobi, Kenya for East Africa; Lagos, Nigeria for West Africa and Morocco for North-West Africa. Around 1600 people are employed in Africa.

BASF’s best teams are formed by attracting talented individuals, retaining them, and helping them to develop further. BASF’s success as a company relies on the personal engagement of their employees. With this aim in mind, they create a work environment which inspires and where everyone interconnects. They encourage staff to develop their strengths, and they recognise their achievements. This approach is based on an open management culture, which is founded on mutual trust, respect, and motivation. With an incredibly wide range of positions on offer, they are well-placed to recruit Africa’s top talent. An exciting variety of roles, performance-related compensation and extensive opportunities for international development are just some of the factors that attracts attention. In addition, a healthy work-life balance is a key priority for all at BASF. At BASF, employees come together in interdisciplinary and global teams to realise exciting projects. That is what they call the power of connected minds.

BASF’s awards as ‘top employer’

They are only truly satisfied when internal and external perception and acknowledgment as an employer are consistent. The World’s Most Attractive Employers ranking reveals top choices for today’s young talent. Each year, 3000 companies are nominated in over 50 markets as preferred employers by students and professionals. BASF is ranked among the Engineering Top 50 worldwide.

Onboarding

The ‘Be part’ programme welcomes all new employees into BASF. The company provides the employee with the best support from the very first day, so that he or she quickly finds their bearings at BASF. The employee is given the opportunity to become acquainted with BASF, to fully develop their strengths, ideas, and expertise, and to build a network with fellow colleagues. BASF have also created specific processes for the employee’s further professional development, which the employee will tailor to his or her needs together with their manager. Right from the start, an experienced colleague is at the new employee’s side to support him or her during his or her first weeks at work. Several information events give the new employee orientation and an overview about the BASF world. Together with their manager, the employee will define his or her individual goals and training modules. Furthermore, BASF offers various opportunities to build up and expand the employee’s network at BASF. ‘Be part’ reaches far beyond the first days in the company. In three phases, BASF will get the employee on board until he or she really feels at home.

Getting started: Welcome to the new team

On the first day, the initial contact partners will welcome the new employee, help him or her get to know his or her colleagues and familiarise themselves with their working environment.

Getting up to speed: Time for action

The new employee now knows their colleagues, duties and goals. The employee has become familiar with their direct working environment and have everything they need to fulfil their duties to the best of their abilities. Now, they are ready to become more closely acquainted with and understand BASF's structure and strategic approach.

Working and developing: Drive things forward

The new employee has now really settled in. They understand the corporate culture and act accordingly. They extend their network on a daily basis and know how to make use of their contacts. It is now a question of how to introduce their ideas and develop further – for themselves and for BASF.

Discover how employees create chemistry with you@BASF

What differentiates BASF from other employers?

BASF does a great job in ensuring that you have options to keep your personal and professional life in balance. The company values diversity as a key component to business success and allows you to openly contribute your ideas to drive creative solutions for our customers.

What has been your proudest achievement so far at BASF, and what would you like to accomplish in the future?

My proudest achievement thus far would be me having the opportunity to serve in several roles, which has allowed me to develop many skills, talents, and impactful knowledge in both technical and business functions. I have had the opportunity to expand my internal and external network by working on several cross-functional teams. In the future, I would like to utilise my 'people skills' to serve in a leadership capacity.

What BASF expects from their leaders

As role models, leaders should demonstrate values and standards of conduct to a high standard. BASF's leaders serve as role models in implementing BASF's strategy in their day-to-day business. The leadership culture is based on BASF's strategic principles and values as well as on the standards of behaviour set out by the globally uniform Code of Conduct. The global competency model applies for all employees. It forms the foundation of BASF's employee and leadership development. All new leaders at BASF take part in the New Leader Program, a modular development programme focusing on the enhancement of fundamental leadership skills, self-reflection and networking. BASF supports experienced leaders with individual offers for honing their competencies. They furthermore serve as internal trainers or observers in our development measures to promote the development of others. BASF offers multifaceted global, regional and local programmes to increase connectivity and exchange. The Employer Branding Campaign of BASF is available at https://www.basf.com/de/company/career/why-join-basf/what-you-will-get/you-at-basf-stories.html.

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12.1 Introduction

Internationally renowned HR consultant and Stanford University business professor, Jeffrey Pfeffer, contends in his books *Competitive advantage through people* and *The*

human equation: Building profits by putting people first that what separates top-performing companies from their competitors is the way in which they treat their human resource planning.[1] He goes on to argue that companies that invest in their employees create long-lasting competitive advantages that are difficult for other companies to duplicate. However, the process of finding, developing and keeping the right people through human resource planning remains one of the most difficult and important of all management tasks.[2] To assist in this regard, this chapter is structured around the various parts of the human resource management process: determining human resource needs, and attracting, developing, motivating and retaining staff within the labour legislation framework.

Accordingly, the chapter begins by reviewing how human resource planning determines human resource needs, such as the kind and number of employees an organisation requires to meet its strategic plans and objectives. Next, the chapter explores how organisations use recruiting and selection techniques to find and hire talented employees to fulfil those needs. The section that follows examines how training and performance appraisal can develop the knowledge, skills and abilities of human resource planning. The chapter continues with a review of compensation – that is, how organisations can keep their talented workers through effective compensation practices.[3] The chapter then addresses the important aspect of motivation. The last part of the chapter focuses on the influence of related labour legislation on the employment relationship.

12.2 The relationship between line management and the human resource department

12.2.1 The role of human resource management in the organisation

The **human resource function** is a crucial element of organisational success. This section considers certain aspects of human resource management in organisations, such as the role of the human resource function, human resource management and **organisational effectiveness**. It then looks at the person who performs the human resource function in organisations.

12.2.1.1 The human resource function

Today, human resource management strategies should be integrated with organisational plans and should be in line with the broad organisational strategy. The human resource function is concerned with much more than routine administration actions and record-keeping activities. Its main role should be that of strategic partner, and human resource strategies should clearly demonstrate the organisational strategy regarding people, profit and overall effectiveness. One of the functions of HR within the organisation is that of strategic partner. Today's HR professionals must understand technology and the business in conjunction with the specialist HR fundamentals. HRs job is not just to assist employees and make everyone happy, but to contribute to the business objectives by performing its support role to its stakeholders. (The BASF case study at the beginning of the chapter illustrates the link between brand value and strategy with people investment.) Various international competitive studies have indicated that labour productivity is a factor that must be addressed in order for South Africa to be competitive in a global market. In the South African context, one of the crucial roles of the human resource (HR) manager is to improve the skills base of

employees and to contribute to the profitability of the organisation. The human resource function must be accountable for its actions and it should operate as a 'profit centre'.

The emphasis on accountability is even more important if one considers the legal environment in which decisions related to human resources have to be taken and the very negative consequences for the organisation if the right decisions are not made. If, for example, the correct procedures as prescribed by the Labour Relations Act (No. 66 of 1995) are not followed in the event of a retrenchment, the consequences for the organisation can be dire.

Every manager in the organisation should realise the importance of recruiting, selecting, training, developing, rewarding, assisting and motivating employees. However, to achieve organisational success both locally and internationally, the focus should be on integration and teamwork among employees.

12.2.2 Human resource management and organisational effectiveness

An effective organisation must have a vision, a mission and strategy, an organisational structure and human resources. It is people in organisations who create the ideas and allow organisations to prosper.

Even the most capital-intensive organisation needs people to run it. Studies have shown that successful organisations all share the following human resource management attributes:

- Primary benefits – monetary benefits like pay, pension and share options;
- Secondary benefits and working conditions – non-monetary benefits like leave allowance, flexible working conditions, input channels, innovation, recognition and the availability of well-being policies;
- Training and development – the availability of function-related development initiatives and programmes; how the employer helps you to grow in your role;
- Career development – includes long-term career path development, talent management, succession planning and performance management; and
- Company culture and diversity – the combined efforts of the employer to establish a strong company culture, i.e. social and networking opportunities, diversity initiatives, corporate social responsibility programmes and employee input.[4]

These findings are also in line with the profile of the most promising organisations in South Africa. Human resources in organisations thus either limit or enhance the strengths or weaknesses of organisations. While it is easy to evaluate other resources such as machines and equipment in terms of their monetary value, it is very difficult to put a monetary value on people. Various research projects – for example, human resource accounting practices – have been launched to do this, but a conclusive methodology and process have not yet been established.

For organisations to be really effective, top managers should treat human resources as the key element of effectiveness. The contribution of human resources to organisational effectiveness includes the following:[5]

- Assisting everybody in the organisation to reach stated goals;
- Making efficient use of the skills and abilities of the human resource planning;
- Providing the organisation with well-trained and motivated employees;
- Assisting in the attainment of the employees' job satisfaction and self-actualisation;
- Developing a quality of work life that makes employment in the organisation desirable;

- Assisting with the maintenance of ethical policies and socially responsible behaviour;
- Managing change to the mutual advantage of individuals, groups, the organisation and the public;
- Executing human resource functional activities in a professional manner; and
- Being involved in strategic decision-making and strategy formulation of the organisation.

12.2.3 Who performs the human resource function?

As soon as a new person (employee) is recruited and appointed in an organisation, management's main concern must be to get that person to do his or her work as well as possible. In this process, certain functions have to be performed by the human resource specialist, who would normally be situated in a human resource department, as well as by line managers and direct supervisors. Line managers are those people in other departments, such as operations, marketing and finances, who have the responsibility to make optimal use of all the resources at their disposal.

The human resource is a unique resource because if it is not properly managed, effectiveness can decline drastically. For this reason, it is essential to understand why people work in organisations and why some people want to perform better than other people. In South Africa, where there is high unemployment, having a job has become an important goal and people compete fiercely for jobs. It is thus important for managers to take note of the complex issues motivating employees and to manage these. In most organisations – apart from capital-intensive organisations – the investment in people has more effect on organisational success than investment in other resources such as materials, equipment or capital.

In large organisations, the human resource function is mainly co-ordinated by the human resource department. In smaller organisations that do not have human resource departments, the main human resource functions (for example, recruitment and selection, scheduling of work, training and development, performance management, compensation and labour relations) are performed by line managers over and above their normal duties. As the organisation grows and increases in size, the line manager's job is divided up, and some aspects, such as recruitment and selection, become more specialised.

These duties are then dealt with by a human resource specialist.

Depending on the nature of the organisation, a human resource specialist is normally employed in organisations with approximately 76 to 100 employees.[6] In South Africa, the ratio of full-time human resource specialists to employees is 50, while the global average is about 62.[7] A human resource department or section is typically created when the number of employees in an organisation reaches a figure of between 200 and 500.

This discussion on the role of the HR manager makes it clear that organisations cannot be successful without well-trained and motivated human resources. Both human resource specialists and line managers are responsible for managing the talent in organisations. One aspect that can make a difference in achieving organisational success is the level of employee motivation, which is dealt with later in this chapter.

12.3 Human resource planning

Human resource planning is the process of using an organisation's goals and strategy to forecast the organisation's human resource needs in terms of finding, developing and

keeping qualified human resources (see Figure 12.1). Human resource planning can be divided into three phases, which is discussed below.

12.3.1 Phase 1: Identify the work being done in the organisation.

Work in organisations is done by employees who are appointed to specific positions (jobs) with the purpose of executing those tasks associated with that position. To identify a position in an organisation, a job analysis process is followed, which generates two outcomes: a job description and a job specification. Once the various positions have been decided upon, they are normally organised into a specific organisational structure (see Chapter 8). The job analysis, job description and job specification process are explained below.

12.3.1.1 Job analysis

The first step in human resource planning is to determine the nature of the work being done. **Job analysis** is the process by which management systematically investigates the tasks, duties and responsibilities of a job within an organisation.[8]

The following questions might be asked when undertaking a job analysis:

- What is the employee responsible for?
- Which tasks are performed?
- Which decisions are made?
- What information is needed to enable the work to be done?
- Under which conditions is the job performed?

There are various ways in which this information can be collected. One method is observation by a qualified job analyst. The job analyst observes the employee working and records all the relevant information. Observation may also include videotaping, audiotaping and electronic monitoring. This method is especially suited to manual labour, where it is easy to see exactly what the employee is doing. However, administrative work is more difficult to observe.

The method generally followed for administrative work is interviewing, where the job analyst interviews an employee and asks for a description of responsibilities and tasks.

Questionnaires may also be used. Here the employee (and sometimes his or her immediate superior) answers a number of specific questions about the tasks and responsibilities of the job. Questionnaires may be developed for specific circumstances, or standardised questionnaires (which are more economical) may be purchased from external vendors.

12.3.1.2 Job description

Whichever method of data collection is used for job analysis, the information is put in writing in a certain format – a **job description** – so that other people who are not involved in the job analysis can gain thorough insight into the contents of the job.

A job description does not merely list a number of facts. It is usually prepared in a predetermined format so that it is easily readable. It generally starts with the job title, purpose of the job, what the position holder will have to do (for example, role, responsibilities, tasks and duties), how the job must be done and under which conditions. It could be followed by a brief description of each main task, with more detail and practical examples as subdivisions.[9]

A description of the kind of decisions that need to be made by the employee may follow, as well as the relevant lines of authority.

The format of the job description differs from business to business. The important point, however, is that the content of jobs must be put on record in an understandable way.

12.3.1.3 Job specification

The personal qualifications an employee must possess in order to perform the duties and responsibilities depicted in the job description are contained in the job **specification.**[10] Typically, job specifications detail the knowledge, skills and abilities relevant to a job, including the education, experience, specialised training, personal traits and manual dexterity of the person doing the job. At times, an organisation may also include the physical demands the job places on an employee.[11] These might include the amount of walking, standing, reaching or lifting required of the employee.

12.3.2 Phase 2: Human resource forecasting

A further step in human resource planning is to conduct regular forecasts of the quantity and quality of employees the business is going to need in the future. As indicated in Figure 12.1 on page 365, the purpose of **human resource forecasting** is to balance **human resource supply** and **human resource demand**. Demand is affected by business objectives because these objectives determine the number of people needed to attain them. Supply is affected by the human resource programmes providing the human resources. The following factors should be considered during forecasting:

- **Economic growth**. This involves forecasting the expected growth (or shrinkage) of the business in view of probable economic developments. For example, will there be a recession or growth in the near or distant future?
- **New developments in the business**. These include planned physical extensions, the establishment of new branches and technological changes (especially those that will affect staff, for computerised machinery might create a greater need for technically skilled employees).
- **The labour market**. Important questions in this regard include: Are there sufficient opportunities in the labour market, or is there a high level of unemployment? What will be the nature and scope of labour turnover in the future? Will there be a shortage of a certain type of skilled employee? Will employees be readily available?

After the predicted human resource supply and demand have been assessed, a surplus or shortage of human resources can be identified. This will form the basis of developing a human resource plan for the organisation.

12.3.3 Phase 3: The human resource plan

Using the information obtained thus far, the HR manager can compile a human resource plan, the final step in the process. The purpose of this plan is to provide concrete guidelines and steps that indicate how the business's short-, medium- and long-term human resource requirements can be provided for. In other words, it answers the question: What must we do today to be prepared for tomorrow? The human resource plan should dovetail with the strategic plan of the business, as mentioned earlier. In the case study earlier in this chapter, it became obvious that the success of BASF is dependent on future human resource needs. It is important to define and align your organisation's talent management strategy with the goals of the organisation.

Such a human resource plan might, for example, make provision for an active recruiting campaign, emphasise the need for intensive training programmes or even

make a strong recommendation to automate because of a possible shortage of human resources.

This stage concludes the process of human resource planning. The next activity in the process is finding qualified talent.

12.4 Finding qualified talent

12.4.1 Recruiting

The express purpose of **recruiting** is to ensure that a sufficient number of, and competent, applicants apply for the various jobs in the business as and when required. Therefore, as soon as vacancies occur, the HR manager must decide from where suitable candidates for the job will be obtained. There are two basic sources: recruitment from inside the organisation and recruitment from outside the organisation.

Figure 12.1: A procedure for estimating the human resource shortage or surplus for a job or occupational category

Source: Anthony, W.P., Kacmar, K.M. & Perrewé, P.L. 2002. *Human resource management: A strategic approach*. Fourth edition. Mason, OH: South-Western, p. 127. Reprinted by permission of Dr W.P. Anthony.

12.4.1.1 Recruitment from inside

Recruitment from inside **(internal recruiting)** means trying as far as possible to fill vacant positions with existing staff members, except for jobs on the lowest levels. In practice, it means that people from outside are appointed only at the lowest level and that all more senior jobs in the hierarchy are filled by means of promotion (or sometimes lateral transfers) of existing staff. When a job at a very senior level becomes vacant, the result is a whole series of promotions.[12] This is, however, not always possible and external recruitment for specialised positions are inevitable. Whatever a business decides, it also has to take into account labour legislation such as the **Employment Equity Act (No. 55 of 1998)** and the **Labour Relations Act (No. 66 of 1995).**

Several methods can be used for internal recruitment, namely talent inventories, career development systems, acting and secondment arrangements, job shadowing and supervisory recommendations.

The advantages of a policy of recruiting from inside are the following:

- Career planning becomes possible, in that individual employees see a future for themselves in the business. This has a positive effect on morale. Succession management is implemented by an organisation to prepare employees who are 'ready now' for their next role, and this is aligned with their lifelong-learning.
- Assessment of applicants is easier because the business already has considerable information on the possible candidates' abilities, work performance and potential.
- The cost of recruitment is low because advertising, travel and board-and-lodging expenses are largely eliminated.

However, there are also disadvantages connected with such a policy:

- The business tends to stagnate because staff members often think like their predecessors. There are therefore no new ideas, and this impacts innovation and creativity negatively.

- Staff appointed at lower levels do not necessarily have the potential to fill senior management posts. If people with high potential are appointed at the lowest levels, they might not be prepared to wait long for promotion opportunities.
- There can be a lot of personal competition among colleagues, to the detriment of co-operation between them.

12.4.1.2 Recruitment from outside

Recruitment from outside means looking for suitable applicants outside the business when a post becomes vacant **(external recruiting)**. External sources of recruitment include employment and recruitment agencies, referrals, professional bodies, educational institutions, and social media and the Internet (see section 12.4.1.4). The use of social media to recruit is illustrated in the BASF case study through the targeted methods of their 'Talent Community' initiative.

Recruitment from outside has the following advantages:

- An active effort is made to obtain the right person for the job – that is, someone with the most suitable qualifications and experience.
- The opportunity is created for bringing in new ideas, schools of thought and approaches, which considerably increase the possibility for innovation in the business.

However, the disadvantages must also be taken into consideration:

- Recruiting costs are considerably higher for items such as advertising and travelling expenses to enable applicants to come from elsewhere for the interview, and the reimbursement of successful applicants' moving costs.
- It is risky because the assessment of applicants can never be perfect. The possibility therefore exists that the successful applicant will not be successful in the job.
- The morale of existing personnel can be negatively influenced. Employees with high potential will not be prepared to stay indefinitely at the same level and might consider resigning.

There are, however, combinations of internal and external recruitment approaches. Most businesses apply both approaches in one of two ways:

- Some businesses first look inside. They only recruit outside if they cannot find a suitable candidate.
- Some businesses advertise all jobs above a certain level, but encourage existing personnel to apply. In this way, management tries to find the most suitable candidate, regardless of whether the person comes from inside or outside.

The BASF case study emphasises the importance of recruiting the right talent with the required capabilities through a variety of methods.

12.4.1.3 The recruiting procedure

If a business recruits from inside, the HR manager must ensure that an efficient human resource record system exists. Such a record system, which is now available in a computerised form known as a **human resource information system (HRIS)**,[13] should contain information on each employee's qualifications, training and experience, as well as an assessment of achievements and interests. This information from HRIS also includes the candidates' readiness for the job, which may also be assessed through the organisation's HRIS and talent data. When a job becomes vacant, the HR manager should be in a position to identify the most suitable candidates. The HR manager should also be able to advise on the employee's developmental journey, for example, competencies acquired for their next role, the job enrichment exercises they have

embarked on and achieved, thereby demonstrating the full picture of the employee's skill set, knowledge and capabilities.

Recruitment from outside the organisation is much more complex. The HR manager must know exactly who to recruit, where to recruit from and how people should be recruited. Successful recruitment does not only mean that enough people apply for a job. If too many applicants apply for a job, selection will be a very time-consuming process. The ideal is, therefore, that only those people who are suitable for the job apply.

To begin with, recruitment from outside requires a thorough analysis of the labour market. A **labour market** can be defined as all the people who are able to work and want employment in an area or a country, in relation to the number of jobs that are available in that area or country. For example, certain mines in South Africa draw most of their staff from neighbouring countries. Other businesses, like farmers for example, might employ mainly seasonal workers.

Every labour market has unique characteristics. A characteristic of the South African labour market is that the relationship between skilled and unskilled workers is relatively unbalanced. Obtaining unskilled labour does not appear to be a big problem, while skilled and professional people in certain industries are exceptionally scarce. HR managers must, therefore, know the composition of their company's labour market as well as that of the South African labour market as a whole if they are to recruit effectively.

12.4.1.4 Recruiting methods

The HR manager can employ various **recruiting methods:**[14]

- **Recruitment through advertisements**. This is probably the most common form of recruiting, in spite of its high cost. The compilation and placement of an advertisement is a specialised task, and because it can cost thousands of rands, some companies use professional advertisement compilers. With the implementation of the Labour Relations Act (No. 66 of 1995) (as amended), as well as the Employment Equity Act (No. 55 of 1998), it is crucial that the advertisement be worded neutrally. If a requirement that may preclude one of the disadvantaged groups is set, then it must be a genuine prerequisite for the performance of the job. It has been found that the more specifically the responsibilities for the job are defined, the better are the chances of drawing the 'right' applicants. Qualifying requirements, such as a certain academic qualification or language ability, must be included to limit unsuitable applications to a minimum. An indication of the remuneration offered is also important, firstly to draw the right applicants and secondly to eliminate potential applicants who already earn more. Specifying general requirements such as loyalty, initiative, sense of responsibility and drive in the advertisement is superfluous, because it never deters an unsuitable person from applying for a job. Advertisements may be placed in journals and newspapers or on bulletin boards (printed or via the Internet and social media).
- **Recruitment through private employment/recruitment agencies**. Although HR departments have increased their use of recruitment agencies, some use them only as a last resort due to the expense involved. In some instances, the employer has to pay a percentage of the applicant's first-year salary as a fee to the agency. The use of human resource consultants is especially suitable for smaller businesses for which the services of a full-time HR manager cannot be justified. Such businesses inform a consulting firm of their needs, and the latter undertakes all the recruitment, including preliminary selection and recruitment administration for the business. In

most cases (depending on the job level), the consultant recommends two or three applicants to the business, which must make the final choice. Effective recruitment agencies can save the organisation time and money by screening out unqualified applicants and locating qualified ones.

•**Recruitment through existing employees**. Existing employees are asked to recruit friends or acquaintances for the business. The rationale of this approach is that if members of staff feel positively about their work, they will more easily persuade others to apply. This method obviates the need for advertisements.

•**Recruitment through personal approach**. This method is often called head-hunting. An individual known personally to the management of a business or consulting firm is approached and offered a job. This method saves a lot of recruiting costs but has the disadvantage that the person cannot be weighed objectively against other applicants. The selection process takes place before the recruitment process, in that the business first decides to appoint an individual to a specific job and then asks him or her to consider the appointment.

•**Recruitment through radio, TV and the Internet (e-recruiting)**. Recruiting over the years has always used technology – first was advertising in print, then radio, then TV and, even later on, the Internet. The Internet and electronic advances have changed recruiting practices. E-recruitment refers to online recruitment, which includes technology or web-based tools to assist the recruitment process by placing advertisements on the Internet. E-recruiting tools include, for example, a job website, the organisation's website or intranet, and social media recruitment (Facebook, LinkedIn and twitter). The Internet has changed HR's recruitment process from the perspective of the organisation as well as the job seeker. E-recruitment uses the Internet to identify and attract potential employees by advertising job vacancies online and making all information pertinent to the job available online.

•Some of the benefits or advantages of the e-recruitment process are listed below:

»E-recruitment involves a shorter recruiting cycle time, improving HR's efficiency in the recruiting process.
»It attracts passive job seekers.
»It is not limited to local candidates, but provides wider –even global – coverage.
»It may address targeted labour market niches.
»It reaches a wider range of applicants, broadening the selection pool.
»It results in lower hiring costs.
»It makes it easier to apply for job.

•E-recruitment is where various social media are used to reach the talent that is required. Social media provides a captive audience for recruitment, thus allowing the employer the opportunity to reach the required talent. Disadvantages of using e-recruitment are as follows:

»It attracts a huge volume of unqualified candidates.
»It can result in outdated resumes.
»E-recruitment tools may not be user-friendly.
»There is a lack of personal engagement and relationship between the candidate and the organisation.

•**Sundry recruiting strategies**. Businesses often use visits to schools and universities to draw students' attention to employment opportunities. The intention is not so much to recruit for specific jobs, but with long-term objectives in mind. The allocation of study bursaries with a compulsory period of service linked to them is

another method of drawing candidates with high academic potential. Other techniques available to the HR manager to ensure a sufficient flow of suitable applicants from whom appointments to the business can be made include participation in career exhibitions and the distribution of general recruitment brochures.

Once applicants have been recruited, the next step is to select the best candidates.

12.4.2 Talent selection

Selection is the process of determining which individuals are best suited to fill positions in the organisation, taking into account individual differences, the requirements of the job, and the organisation's internal and external environments.[15] The process will, however, differ from organisation to organisation, and depends on the level of the appointment. Figure 12.2 depicts five phases in a typical selection process.

The process described below, however, is the more intensive approach followed in the selection of applicants for senior management posts. For this reason, not all the phases indicated in Figure 12.2 are followed in this discussion.

The selection process to be used for senior management posts can be divided into the following three phases:

1. Preliminary screening
2. Intensive assessment
3. Final selection.

It is also necessary to ensure that the organisation has a competency framework consisting of both behavioural and knowledge or technical competencies. During the selection process, it must be clear which competencies are required for a particular position to ensure that an informed choice is made.

With the implementation of the Labour Relations Act (No. 66 of 1995) and the Employment Equity Act (No. 55 of 1998), a number of important components of the selection process (including the application form, the interview and the tests used) have been affected. For example, the application form must not contain discriminatory questions such as questions about marital status. Moreover, these types of question may not be asked during the interview, and the various tests used must not be culturally biased (see Section 12.8).

Figure 12.2: The phases in the selection process for a position in an organisation

12.4.2.1 Preliminary screening

The most efficient method for separating undesirable candidates from potential applicants is to compare the application with the job specification (Phase 2 in Figure 12.2).

A great deal of information can be included on the application form. What is asked depends largely on the needs of the specific business and the nature of the selection process. An application form usually requests the **personal details** (for example, name, address and educational qualifications) and **work history** (for example, jobs held in the past, reasons for resignation and salary progress) of the applicant. References are

usually requested – that is, persons or institutions who can be approached to support the information given on the form (Phase 2 in Figure 12.2).

Questions can also be asked about the applicant's significant achievements, disappointments, career expectations, and communal and leisure-time activities. What is important is that the application form serves as a preliminary selection instrument. In this preliminary selection, the HR manager should learn answers to the following questions:

- Does the applicant comply with the minimum requirements as given in the job specification?
- Which type of jobs did the applicant hold in the past?
- How quickly did he or she progress? This demonstrates agility to progress.

After these activities have been completed, the next step is to have a short interview with the applicants who, according to information in the application form, are suitable candidates (Phase 3 in Figure 12.2). This interview provides the HR manager with the opportunity to form a general opinion of the applicant based on appearance, articulateness and self-confidence. It also gives the applicant the opportunity to obtain more information about the business and the specific job.

A preliminary interview is usually not practical for applicants who would have to travel far. They would instead be invited to report for a more intensive assessment.

12.4.2.2 Intensive assessment

Intensive assessment basically involves two steps: **psychological testing** and **diagnostic interviewing**. Although medical selection usually forms part of the final selection process (Phase 4 in Figure 12.2), it is advisable to have the applicant assessed medically first if the job has stringent physical requirements – for example, in the case of an airline pilot. However, the use of general medical tests in South Africa could have legal implications for the business, depending on the results of the medical examination. Businesses must avoid any hint of discrimination in their interpretation or use of these results.

- Psychological testing can provide valuable information about an applicant. Tests usually involve a measurement of the applicant's personality, abilities and management skills (Phase 2 in Figure 12.2). An important aspect here is to ensure that the tests used are not culturally biased, as mentioned earlier. Some HR managers have the qualifications required for doing testing themselves, while others have the testing done by professionals. However, it is important to remember that a test can never predict accurately whether an applicant will be successful or unsuccessful. Test results only give a general indication that must be considered together with other factors. Here again, competency assessments should be used to ensure that the right person–job fit is maintained.
- A diagnostic interview is used to obtain information that was not highlighted in the tests or on the application form (Phase 3 in Figure 12.2). A good interviewer looks for certain characteristics by asking specific questions about the applicant's past performance. For example, an applicant's initiative can be assessed by asking about new projects that he or she may have initiated in previous jobs. The interview also gives the HR manager a chance to delve deeper into possible shortcomings indicated by tests. If, for example, the interviewer suspects that the applicant does not always have good relationships with other people, questions can be asked about interpersonal relationships. However, as mentioned previously, questions of discriminatory nature must be avoided. The interviewer may not ask any questions about the person's religious convictions or sexual preferences, for example. The key

to good interviewing is to ask questions that give no indication of the expected answer. Some HR managers prefer to do diagnostic interviews alone without involving the line functionaries under whom the applicant will work. Others, however, find it useful to include line functionaries at this stage. They may even ask these functionaries to be involved in the interview.

12.4.2.3 Final selection

At the stage of **final selection**, there is usually enough information available about the applicants to compile a **shortlist** of approximately three persons.

Before the applicants on the shortlist are weighed up against each other, the HR manager must consult their **references** to confirm the information they have provided. (In Figure 12.2, this was done before the diagnostic interview. However, there is no right or wrong stage at which to consult references.) Some HR managers do not attach much value to references because applicants would not refer HR managers to people who did not have a high regard for them. Therefore, it is not, in fact, worth very much simply to ask referees for an opinion about the applicant's suitability. However, if referees are asked to confirm information (whether positive or negative) obtained in the intensive assessment phase, they can make a very valuable contribution to the selection process.

In the final **comparison of applicants**, it may be useful to interview all three (or two) again briefly. What is essential, however, is to record the strengths and weaknesses of each of the final applicants in writing before the final decision is made. These documents must be kept for record purposes should a problem arise in the future.

After the most suitable applicant has been decided on, the person concerned is offered the job (Phase 5 in Figure 12.2). This is the time to explain what is expected of the person in the job and to advise what the conditions of employment are. The applicant can then decide whether to accept the job.

12.4.2.4 On-boarding

Once the job offer has been accepted, the new employee must report for duty as soon as agreed on between the employer and the candidate. With the placement of the person in the job, a number of outstanding matters can be finalised. The business might need to make arrangements for the transportation of the new employee's furniture and organise temporary housing for him or her. Missing information and documents such as copies of education certificates must be collected, and the forms authorising tax and medical-aid contribution deductions must be completed.

The new employee must go through a process of **on-boarding** (also known as induction, **orientation** or **socialisation)**. On-boarding is the process of introducing the employee to the organisation and to make him or her familiar with the details and requirements of the position (see BASF onboarding initiatives). Experience has shown that when employees do not do this, it takes much longer for them to start working productively.

An induction programme will achieve the following:[16]

- Introduce new employees to their colleagues, and facilitate and expedite the socialisation process;
- Explain the business's policy, procedures and rules to new employees so that they are aware of the environment in which they will be working;
- Inform new employees about the business's history, products and services, as well as its reputation in the market (this serves to fix the new employees' attention on

their futures and to make them aware of the contribution they might make to the realisation of the business objectives);

- Inform employees about practical arrangements – for example, payment procedures, overtime payment, incentive systems, eating arrangements and leave benefits; and
- Inform employees about the organisational structure of the business, and show them where they fit in and which communication channels are available to them.

Once employees have been recruited, selected and placed in their jobs, the next step is training. This involves providing them with the skills, knowledge and abilities they need to perform their jobs successfully.

Off-boarding is the process in which an employee leaves the service of the organisation due to retirement, resignation or any other reason. This process is also a very important phase in the life of an employee and the organisation because it entails important processes such as exit interviews, returning company property, completion of exiting forms and, for those who retire, pension calculations, to mention but a few. Good practice indicates that organisations should have an off-boarding policy in place.

Critical thinking

E-recruitment is becoming more popular and technological innovations in the World Wide Web have changed employee recruitment and selection practices over the past decade. The question that needs to be asked is: what is the applicant's perception of the online application procedure and web-based recruitment practices? Are the applicants in favour of or against e-recruitment?Consider the advantages and disadvantages of using e-recruitment.

12.5 Developing talent

12.5.1 Human resource development (HRD)

Developing talent contributes to both the personal and professional development of employees. Such development enhances employee capability and engagement within the role and with the organisation. The HR manager has the dual responsibility of ensuring that the company employs sufficient staff and of creating opportunities for employees to make themselves more valuable to the company. This activity can be subdivided in several ways, but a good method is to distinguish firstly between **training** and **development**, and secondly between **technical** training and **management** training.

Training typically involves providing employees with the knowledge and skills needed to do a particular task or job, although attitude change may also be attempted (for example, in training to create awareness of sexual harassment). **Developmental** activities, in contrast, have a longer-term focus on preparing for future work responsibilities, while at the same time increasing the capacities of employees to perform their current jobs.[17] With the introduction of talent management in organisations, development to next roles is also becoming increasingly more apparent and interventions such as job shadowing and succession management are employed.

While the methods used for training and development are basically the same, the purpose differs. Thus, one person may attend a course on marketing because he or she currently fills a marketing post, whereas another person may be sent on the same

course because management wants him or her to fill a marketing post at some future point. Similarly, a manager may spend time teaching an employee how to do his or her work correctly, but may also spend time teaching the employee to do the manager's work with building leadership capacity and succession management as the goal in mind.

For our purposes, we will speak of **development** as the overall concept, with the understanding that it includes both training and development in the narrower sense of the word. We can thus define **human resource development** as a set of systematic and planned activities designed by an organisation to provide its members with the opportunities to learn necessary skills to meet current and future job demands. Consequently, learning is at the core of all HRD activities.[18]

The word 'technical' refers not only to tasks performed in a workshop, but any task that has to be performed physically. Accordingly, the keeping of journals is just as technical as the repair of a machine. In its wider sense, we use the word 'technical' to refer to all non-management tasks. By 'management', we mean tasks undertaken to achieve business goals such as planning, organising, leading and controlling people, finances and physical resources (see Chapter 6).

HRD activities should begin when an employee joins an organisation during the on-boarding process and continues throughout his or her career, regardless of whether that employee is an executive or a worker on an assembly line. HRD programmes must respond to job changes, and must integrate the long-term plans and strategies of the organisation to ensure the efficient and effective use of resources.

The HR manager does not have to train other employees personally (usually there are HRD professionals to do this), but he or she is primarily responsible for providing development facilities and courses. The HR manager must ensure that the employees are given an opportunity for training and development, and that they are encouraged to develop to higher levels of competence.

It is evident in the BASF case study that a considerable amount of time and effort is spent on developing employees. BASF shows effort in speaking to, applying and leveraging the talents of their employees. BASF employees are provided with the right environment to thrive, learn and develop, thereby optimising creativity and innovation in the minds of its employees. Innovation sits at the heart of everything BASF does, therefore BASF makes a great effort to continuously improve their team's performance, thereby enhancing the power of innovation, and increasing creativity, motivation and identification with the company.

12.5.2 Development methods

It is, firstly, critical to consider the organisation's strategic objectives with the sets of competencies required to accomplish these objectives. Subsequently, a skills audit and gap analysis should be conducted before development may begin. Development programmes may be used as an organisation's change agent mechanism.

It is important to note the changing career preferences from the employment relationship of job security for loyalty to the changed employability for performance and flexibility; from working for one or two organisations throughout one's lifetime to working for a number of organisations through one's lifetime; from success being measured through pay, promotion and status to the new career of psychologically meaningful work; from the organisation taking responsibility for the employee's career management to the individual himself or herself assuming responsibility; from an environment that is required to be stable to one that needs to be dynamic; from formal training programmes to on-the-job training; from a career horizon that is long to one

that is now considerably shorter; and from a linear career direction to one that is multidirectional.

Once training has been designed, the delivery can begin.

Different formats can be used for training and development activities, but the most general formats are:[19]

- on-the-job training and development; and
- away-from-the-job training and development.

12.5.2.1 On-the-job training and development

On-the-job training and development involve job instructions given by an employee's supervisor or an experienced co-worker. Trainees learn by observing experienced employees and by working with the materials, personnel or machinery that constitute the job. Therefore, the transfer of training is high.

On-the-job training includes the following methods:

JOB ROTATION

Job rotation is when a staff member is moved to a new job as a means of enriching and stretching the staff member, provided the staff member knows the current job well. The rotation can be short term, for example, for two weeks in every job, or long term, for example, for one year in every job. The latter usually applies to more senior management jobs and is often preparation for a general management position. What is important is that the development does not take place at random. In this way, the monotony of the job is reduced, it contributes to creating the right employee–job fit, tests employee skills and competencies, and provides further exposure to employees. Job rotation should be executed with an end goal in mind – for example, if the goal is the development of individual employees for eventual promotion or to advance the employee's career options to avoid job boredom, or to create backup help, the job rotation plans will differ. It is important to note that job rotation requires targeted development to ensure general competencies.

JOB SHADOWING

Job shadowing is a type of on-the-job employee training. It is an intervention that supports an employee who desires to become familiar with a job. This occurs by means of following and observing a trained, knowledgeable and experienced employee in the field. The advantages of job shadowing include the following:

- Job shadowing is effective when an employee wants to learn more about different jobs in the organisation. It allows the individual to gain comprehensive and practical knowledge about what an employee who holds a particular job does in that job every day.
- It is effective for employees who may want to test their interest and capabilities in a career by finding out what happens in a particular job every day.
- The seeing, as opposed to the telling, element of the intervention is regarded as a key element of learning the job. This allows an employee to experience the realities and nuances of what the job means and what is required to perform it.
- The participant experiences the employee's approach, the interpersonal interaction required, the steps and actions necessary, and the components needed to perform the job effectively that the employee might never think of mentioning.
- The shadowed (person who is providing support and guidance to the employee) creates space for the shadow (person who requires support and guidance), such that after the job shadowing programme is over, the shadow is able to perform in the

role of the shadowed. Job shadowing enhances employees' job mobility within the organisation.

ENLARGED AND ENRICHED JOB RESPONSIBILITIES

By increasing the employee's duties, responsibilities and autonomy, the organisation will allow the employee to learn more about the job, department and organisation. Redesigning the job can be seen as a training and development approach, because the employee can be stretched and tested in new ways. A stretch assignment is a project or task given to employees that goes beyond their current knowledge or skills level in order to 'stretch' them developmentally. These stretch assignments are meant to challenge employees by placing them in uncomfortable situations in order to learn and grow. In this way, the organisation will build capability, increase employees' confidence and engage and retain talented employees.

JOB INSTRUCTION TRAINING

Job instruction training (JIT) is a series of steps that supervisors follow when training their employees. JIT is simple to use and applies a common-sense approach, so it remains a popular tool for many modern trainers. The simple steps in JIT are preparation, presentation, performance try-out and follow-up.

COACHING

Development in the organisation can also occur through coaching by the employee's immediate supervisor. The superior may, for example, give his or her employee certain responsibilities and show the employee how to perform certain tasks. Most coaches also encourage their employees to discuss difficult situations as they arise and work together through alternative scenarios for dealing with them.

MENTORING

Mentoring is a developmental partnership through which one person shares knowledge, skills, information and perspective to foster the personal and professional growth of someone else. Everyone needs insight that is outside of his or her normal life and educational experience. The power of mentoring is that it creates an excellent opportunity for collaboration, goal achievement and problem-solving.

APPRENTICESHIPS (LEARNERSHIP) AND INTERNSHIPS

Apprenticeships and internships are formal development, because the employee receives a formal qualification after completion.

In a learnership the employee is allocated to a qualified artisan and so is provided with the necessary practical training. From time to time, the employee must attend a few block courses, usually at a technical institution. After a certain period, the employee receives a certificate if he or she has passed the compulsory examination.

Internships are often part of an agreement between colleges, universities or professional boards and organisations. An internship provides a realistic preview of the job and the organisational conditions in which an employee is likely to work. For students with little experience, internships are clearly structured to achieve specific learning goals.

Learning on the job is participation in practice. It is learning in situations without any visible signs of teaching activities and is the trend that the human resource planning

is taking to keep up with the dynamism of the work environment and the learning process.

12.5.2.2 Away-from-the-job training and development

This method of training and development includes any form of training performed away from the employee's immediate work area.

A wide range of training methods is employed to train and develop employees away from their jobs. These are briefly discussed next.

LECTURES

The lecture is the second most popular away-from-the-job training and development technique, because an education, training and development (ETD) practitioner can provide information to a large group of people in a timely manner. This method, however, has two disadvantages, namely that behavioural skills are not learnt because there is little to no interaction between the learners; and the learners are often bored and may not listen efficiently, because communication is only one way.

CONFERENCES OR DISCUSSIONS

Discussing problems and critical issues in a conference or discussion format permits a dialogue between the trainer and the trainee, as well as among the trainees. Two-way communication takes place that provides trainees with immediate feedback on their questions and ideas and increases their motivation.

SEMINARS

A seminar is presented by an outside institution – for example, a consultant or professional institution. Such courses are normally attended by a variety of employees from various companies. This type of course is especially valuable to smaller companies that want to expose only a few staff members to this type of training and can therefore not present the course within the organisation. The disadvantage here is that training material becomes generalised because it must apply to a number of widely divergent companies.

VESTIBULES OR SIMULATIONS

A vestibule or simulation is created to resemble the employee's actual work area and is performed with the aid of an instructor who demonstrates on the same kind of machine and uses processes the trainee will use on the job. Vestibule training has been used in a variety of positions, which include, for example, retail sales personnel, bank tellers, machine operators and aircraft pilots.

E-LEARNING

E-learning refers to web-based learning, virtual classrooms, computerised learning modules, interactive TV, satellite broadcasts, and other such technology.

Prior to the advancement of computers, employers often made use of programmed instruction (PI) techniques, which allowed trainees to learn the information or skill in small segments and at the learner's own pace. Here, the instructional material was often broken down into frames and programmed for the computer. Each frame represented a small component of the entire subject to be learnt, and each frame needed to be completed before the next one could be tackled.[20]

Web-based training or e-learning takes place on the Internet. The Internet offers training opportunities not bound by time or place. Various universities and organisations make use of the web as a training medium.

Satellite linkages, compressed video (CD) and other videoconferencing techniques are technology-based approaches that are popular and cost-effective for organisational communication and training. Online learning and development modules have been introduced by organisations to ensure that learning takes on various formats to accommodate the differentiated learning needs of the employees. Online learning modules accommodate the varying pace of learning, flexibility of time, and the option to participate. (see for example, Open Educational Resources (OER's) and Massive, Open, Online Courses (MOOCs)).

CASE STUDIES

A case study is a written description of an organisational problem and requires participants to identify and analyse specific problems, develop alternative courses of action and recommend the best alternative. In training and development programmes, participants often form teams to study the case and then present their recommendations for discussion and analysis. The purpose of a case study is to enhance problem-solving skills.

ROLE PLAYING

During role playing, the participants play the roles of those involved in an organisational problem. There are no scripts and participants have limited information on which to base their roles. The goals of role-playing are to analyse interpersonal problems and develop human relations skills.

IN-BASKET EXERCISE AND ASSESSMENT CENTRE

In-basket exercises are designed to develop the analytical and problem-solving skills of lower-level managers. This technique includes a series of hypothetical problems that a supervisor may find in a typical in-basket. The in-basket forces the trainee to make immediate decisions and to set priorities.

The assessment centre is a technique that requires managers to participate in activities designed to identify their job-related strengths and weaknesses. It is used as a device to develop and select new managers.

12.5.3 The danger of the 'shotgun' approach to development

Various organisations use a 'shotgun' approach to development (this means an indiscriminate approach to development). The reasoning is as follows: if a training programme is good for one employee, then it must be good for everyone. So, it is implemented throughout the organisation. From this approach, it is evident that organisations do not take time to conduct a training needs analysis.[21]

The successful HR manager, however, attempts to obtain as much value as possible from development programmes. Firstly, he or she makes a thorough analysis of the development needs that exist within the company and then chooses training programmes on the basis of how specific programmes comply with these needs. Secondly, he or she ensures that training money is spent only on members of staff who show a potential for further development. Thirdly, the HR manager makes plans with the immediate superior of the employee concerned to utilise his or her new skills or

insight in the work situation. Lastly, the HR manager undertakes follow-up studies to determine whether the training programmes have had the desired results.

Thus far, this chapter has focused on some of the most effective methods available to managers for finding and developing top-notch employees. However, having talented employees is not enough. Successful organisations are particularly adept at engaging their human resource planning to achieve goals that benefit the organisation as well as the individual. One of the most helpful tools a company can use to maintain and enhance productivity and facilitate progress towards strategic goals is performance-appraisal programmes.[22] It is clear from the BASF case study that human resource development is a priority. The company focuses on developing employees to drive operational excellence. In addition, BASF is a well-known talent developer world-wide because of the broad range of challenging assignments, training, career patterns, and the opportunity for cross-organisational moves, providing the space and support for employees to make a vital contribution to creating an open corporate culture that values every individual.

Critical thinking

Organisations spend a substantial amount of their human resource budgets on the training and development of their employees. To convince top management that this amount is being well invested, the HR manager has to convince management of the contribution that proper training and development can make to organisational goal achievement. The question, thus, is: Which focus should the training have to achieve this goal? The following should be considered in your analysis.

1. Does the training contribute to the organisation's goals and the employee's developmental goals?
2. Is the training linked to practical outcomes required by the organisation and the employee?
3. Does the training deal positively and successfully with the company's real-time issues?

12.5.4 Performance appraisal

The purpose of a **performance appraisal** is to determine in which aspects the employee has:

- performed exceptionally well (that is, surpassed the requirements for the job);
- complied with the requirements for the job; or
- not complied with the requirements for the job.

Performance appraisal is also called **employee rating, employee evaluation, performance review, performance evaluation** and **results appraisal.**[23] In most organisations, the human resource department is responsible for designing and implementing the performance appraisal system. However, front-line managers play an important role because they often conduct the appraisals. Therefore, it is important for line managers to participate in the programme from the planning stage.

An appraiser has the opportunity to observe an employee's performance over a period of time. This offers the possibility of several different choices of appraisers, namely the immediate supervisor, employees who report to the person, peers, each worker himself or herself, customers and teams.[24]

The more **objective** this appraisal is, the more successful it is likely to be. It is, therefore, important for the HR manager to ensure that there are objective criteria against which the performance of the individual or team can be measured. Thus, an

ideal performance appraisal involves the comparison of work results with quantitative objectives.[25] For example, a salesperson's actual sales are compared with a sales target, a truck driver can be appraised against, among other things, the maintenance costs of his or her truck and a teller's performance may be measured against the number of times he or she did not achieve a balance.

Some performance-appraisal methods also provide for the assessment of an employee's characteristics, such as attitude, enthusiasm, initiative and neatness. However, this type of assessment is much more subjective than the comparison of results with objectives because it depends mainly on the opinion of the immediate superior.

The least-effective form of performance appraisal is the form by which employees are compared with one another in general. In this approach, the employee is assessed mainly on the basis of the **impression** the superior has of him or her, and the risk of prejudice (positive or negative) is much greater.

As a result of the numerous problems that arise out of traditional performance-appraisal methods, an approach called the **360° system** was developed some years ago. This multi-source rating recognises that the manager is no longer the sole source of performance-appraisal information. Instead, feedback from various colleagues and constituencies is obtained and given to the manager, who then interprets the feedback from the various sources.[26]

In practice, and for a number of reasons, formal performance-appraisal programmes sometimes yield disappointing results.

Factors that influence the relevance, reliability and practicality of performance appraisals are the organisational environment; goals of senior management; the norms of a business unit, work group or team; the attitude of managers towards their employees; personal perception and attributes; the criteria used for measuring performance; rating errors; and issues concerning reliability and validity.[27] The **results** of a performance appraisal can be used for three basic purposes:

1. To provide a basis for financial rewards
2. To determine whether the employee should be promoted to a higher level of work
3. To provide the employee with feedback on how well he or she is doing.

A critical aspect in performance appraisal is **feedback** to the individual or team concerned. In order to be effective, the appraiser should focus on the following:

- Give specific examples of desirable and undesirable behaviours, without mentioning real-life situations.
- Focus feedback on behaviour and not the person.
- Give feedback that will allow the employee to be successful.
- Direct feedback towards behaviour that the employee can control.
- Feedback should be timely, concise and specific.
- Limit feedback to the amount the employee can process.
- Use active communication skills.[28].

It is important and necessary to reward employees whose performance appraisals are excellent. The BASF case study evidences the importance placed on high performance, which is recognised and rewarded in the organisation. However, organisations also use compensation to attract the quality and quantity of employees needed, retain those employees, and motivate them towards organisational goal achievement. The following section discusses the important role played by compensation within an organisation.

12.6 Retaining talent

12.6.1 Compensation of employees

Compensation refers not only to extrinsic rewards (such as salary and benefits) but also to intrinsic rewards (such as achieving personal goals and more challenging job opportunities).[29] It is one of the most important factors that motivate an individual to seek employment with a specific company. The other is the nature of the work. If an employee is dissatisfied with his or her compensation, there is a good chance that the employee will not remain with the company for long. The HR manager must therefore ensure that the compensation policy does not lead to a high staff turnover, because a compensation policy will determine whether the organisation will pay leaders or followers, or strive for an average position in the labour market.[30] The case study earlier in this chapter shows that competitive and fair salaries and benefits are paid to the employees at BASF.

Thus, the establishment of a compensation policy is an absolute necessity.[31] Although the HR manager, in most companies, does not have the final say in the compensation policy, it must nevertheless be initiated by him or her. Here are some important points to note when drawing up this policy:

- Firstly, a decision must be made about how the company's compensation in general should compare with that of the labour market. Will it be the same? A little higher? Considerably higher? Or a little lower? What form should the compensation take? How much will be in the form of direct financial compensation? And how much in the form of fringe benefits? The fringe benefits of some companies do not involve more than 30–40 per cent of the total compensation, while those of other companies are as high as 50 per cent.
- Secondly, a policy must be determined on a cost-of-living adjustment. Does every employee automatically receive an increase that corresponds with the consumer price index (CPI), or does each person receive a larger or smaller increase?
- Thirdly, the compensation policy must determine which form rewards will take. Most companies reward by means of salary increases. Other companies, however, only give salary increases in accordance with the rise in the cost of living, and then give cash bonuses to reward good work performance.

12.6.2 Types of compensation

Compensation can be regarded as the output an employee receives for the input (work) he or she produces. **Direct compensation** is the basic salary or wage an employee receives, while **indirect compensation** refers to the fringe benefits an employee receives, such as leave, medical aid and a pension scheme.[32] The other aspect of compensation is **reward** – that is, the recognition of good work performance.

12.6.2.1 Direct compensation

A person who is paid monthly receives a **salary**, whereas someone who is paid daily or weekly receives a **wage**. Most employees' salaries or wages are based on the period of time for which they have worked for the company, measured in days, weeks or months. Thus, there is no direct relationship between the compensation employees receive and the amount of work that they perform. Such a system is simple to administer, but has the disadvantage that, for remuneration purposes (in the short term, at any rate) there is no distinction between productive and unproductive workers. To overcome this problem, some companies use a **piece-wage** system. Here, the employee is

compensated for the amount of work he or she performs, regardless of the time taken to perform the work.

12.6.2.2 Indirect compensation

The **benefits** an employee receives from his or her membership of an organisation are called **fringe benefits**. These benefits increase in size and scope as the employee moves to higher levels in the organisation.

Fringe benefits generally provided are:

- **leave benefits**, for holidays, illness, studies and so on;
- **insurance benefits**, for example, against medical costs, injury and unemployment; these also include life cover and pension benefits;
- **housing benefits**, in the form of free housing, housing at a low rental or loan subsidies for buying a house; and
- **car benefits**, which can vary from a free car with all expenses paid to financial assistance with buying a car.

There are also other types of fringe benefits. These differ from company to company. The important point, however, is that fringe benefits are a form of compensation linked to the hierarchical level of the employee. For example, only staff members above a certain status level enjoy cars as a fringe benefit, and the higher the status level, the more expensive the car.

12.6.2.3 Reward

In most cases, neither direct nor indirect compensation is linked to an individual's work performance, and both forms of compensation are therefore regarded as 'rights' by most employees. Both forms of compensation therefore have very little influence on the motivation of employees. The fact that an employee receives an end-of-year bonus (often equivalent to a month's salary) will not necessarily cause him or her to work twice as hard to merit this in future.

The HR manager must, therefore, ensure that there are other ways of rewarding an individual's work performance. Such rewards can take various forms, some of which include the following:

- The most common form of reward is a **salary increase** based on the individual's work performance (that is, a merit award). A distinction must be made here between the **cost-of-living adjustment** (given to all employees to adjust to the inflation rate) and **merit increases** given in recognition of the individual's achievement.
- Some companies give **financial bonuses** to those employees who have performed exceptionally well.
- Other companies reward outstanding employees with a **paid holiday** or an **overseas trip** with all expenses paid.

To summarise: compensation is part of an agreement and is given to the employee for satisfactory performance. It can, therefore, correctly be regarded as a right because the company is committed to paying it. A reward, however, is not a commitment on the part of the company. It is the company's voluntary acknowledgement of an individual's good work performance.

From the case study it is evident that BASF provides both direct and indirect compensation and rewards to its employees through exposure to diverse roles, performance-related compensation and extensive opportunities for international development.

12.6.3 The amount of compensation

The question that now arises is: How much should a specific staff member be paid by way of compensation (salary and fringe benefits)? We know that a factory manager will probably earn more than a machine operator, but how large ought the difference to be and how much should each person receive?

The first step in deciding on compensation is to make an **external comparison**. How much do factory managers at other companies earn? What is the nature and scope of their fringe benefits? The HR manager must do a **salary survey** to obtain this information.

Salary surveys are undertaken countrywide by different institutions. The HR manager may choose to use such surveys rather than do his or her own survey. However, it is important in such a survey that equivalent jobs are compared with each other. The mere fact that two people have the job title 'factory manager' does not necessarily mean that they do the same type of work. So, for example, a person in control of a small workshop where hand-made chairs are manufactured by three artisans might carry the title 'factory manager', but it is obvious that this job is not equivalent to that of a factory manager in a large motormanufacturing plant.

The second step is to make an **internal comparison.**[33] This means that the value of jobs must be compared with each other in terms of the demands they make on the employee. Accordingly, it may be said that the demands made on an accountant are higher than the demands made on an accounting clerk.

Critical thinking

One of the most significant tasks confronting HR managers is the design and implementation of compensation systems. The primary goal of these systems, which are designed to serve many purposes, is to provide fair and equitable remuneration for all employees. But what are the factors that HR managers need to consider in order to attract and retain employees? Is remuneration the biggest element in attracting, retaining and incentivising employees?

Global Benefits Attitudes Survey: The role of benefits in winning the war for talent

In attracting and retaining talent today, organisations have to provide competitive salaries and benefits. However, organisations cannot win the talent game on compensation alone. To become the employer of choice, organisations need to shape their culture and respond to the values of the employees

According to Willis Tower Watson, the 2017 survey takes an in-depth look at the role of benefits in defining and differentiating today's employee value proposition. The analysis explores the extent to which benefits individually and collectively shape employees' actions; how closely they are aligned with employees' employment and lifestyle priorities and their links to stress, absence, presenteeism and work engagement. Key findings include:

- Benefits matter more than ever. Employees' long-standing desire for greater security continues to intensify. Employees, particularly younger employees, want more benefit choices. Those with choice and flexibility today are twice as likely to feel their benefit programme meets their needs.
- In many countries, employees are increasingly concerned about their finances, both immediate and long term.
- More than one-fifth of employees expect to still be working at age 70 or later. Over 60 per cent say their employer retirement plan is their primary means of saving for retirement.
- Employees look to their employers for support in improving their health and well-being and becoming more financially secure.

•Although companies are responding with programmes that support physical, emotional, financial and social well-being, employees are not that pleased about what they have seen so far.

•Employee engagement in well-being programmes remains low. Designing programmes that leverage the workplace environment and promote the use of new technologies is strongly linked to more positive attitudes about a company's well-being efforts and to health engagement.

Source: Compiled from information in Willis Towers Watson. Global Benefits Attitudes Survey. 2017. For more information go to: https://www.willistowerswatson.com/-media/WTW/PDF/Insights/2017/11/2017-global-benefits-attitudes-survey.pdf [Accessed 12 October 2018].

This internal comparison is known as **job evaluation**,[34] and there are various methods of undertaking it. One method is to rank all jobs in the company in terms of their 'value'. This ranking system is usually used in small-to medium-sized companies, and the assessment is made by a panel of senior managers.

A second general method of job evaluation is the **factor-comparison** method. According to this method, jobs are compared according to the demands they make on the employee in terms of factors such as knowledge, communication skills, level of responsibility and, especially, decision-making skills. Points are awarded to each factor (also known as **compensable factors)**, and the total points indicate into which job grade a specific job falls. The information about the jobs can be obtained from the **job description**. Job descriptions therefore have a twofold purpose:

1. They form the basis for a **job specification**, with a view to recruitment, selection and training.
2. They provide a basis for job comparison, with a view to job evaluation.

It is important to remember that in job evaluation, only the job is assessed and not the job incumbent. The value of the job has nothing to do with how well or how badly the present incumbent carries it out.

Job evaluation in itself cannot indicate exactly how much a specific staff member ought to earn. The HR manager can only determine, in the light of the findings of the external comparison, what the broad salary range of an accountant, for instance, ought to be.

The decision as to what a specific employee ought to earn once he or she is employed will depend on years of experience, qualifications, what other employees on the same level earn and other similar considerations. The question can be decided by the HR manager in conjunction with the line manager. However, the HR manager cannot decide on an individual staff member's reward. That decision can be made only by the staff member's immediate superior. Nevertheless, the HR manager can make an important contribution by ensuring that line managers have suitable instruments for assessing their employees' performances.

12.7 Motivating employees

12.7.1 Introduction

In today's society, notions such as 'people make up a business', 'people are an organisation's greatest assets', 'managing human resources is fundamental to organisational success' and 'motivated employees make a difference' are in general use and are crucial to organisational success. The emphasis has shifted from endeavouring to solve people-related problems in organisations in an ad hoc fashion to a more

professional approach in which the overall organisational philosophy, culture and tone reflect this belief.

The following case study provides an illustration of how theories of motivation are applied in the strategies of a South African company.

12.7.2 Employee motivation

The importance and uniqueness of the human resource in the effective functioning of organisations was discussed in section 12.2.1. Part of the responsibility of the human resource department and line managers is to turn the potential of employees into performance. This involves:

- shifting trends in talent behaviour and aligning strategy with people;
- the changing psychological contract and building a successful employment relationship;
- engagement strategies; and
- recognition strategies at individual level.

CASE STUDY: BASF

BASF, a leading chemical company referred to at the beginning of this chapter, deals with products that range from chemicals, industrial solutions, performance materials, nutrition and care as well as surface technologies and agricultural solutions. Team members are continuously working on developing innovative solutions for customers around the world. Employees' passion, imagination, and determination are crucial to their success as a market leader. Whether you are a recent university graduate or an experienced professional, and you have great ideas and skills, then BASF is the place to make your mark! Although BASF employs over 114 000 people throughout the company, they dedicate themselves to supporting and empowering each individual in finding the right path to their success. At BASF, employees create their own success and satisfaction at work and life with you@BASF, a unique total offer of benefits, compensation, learning and development opportunities, as well as a safe and caring work environment.

Connecting

Bringing People Together: We focus on connectedness.

Employees feel fortunate at BASF, because the company has established certain values in their corporate culture that differentiate them from their competitors. Values that all employees experience and live every day – and one of them is connectedness. Connectedness means good relationships – among themselves and with their customers and partners. This is reflected in interdisciplinary and international projects, at customer events, through social commitment and further initiatives, where one thing is always the focus: Bringing individuals, with all their knowledge, together to solve global problems and create a sustainable future for all. They call that: The power of connected minds.

Engagement

Moving Individuals: Promoting engagement.

Nobody wants to play the same game over and over. If someone wants to make a difference and create something new, one has to explore new ways. Try it out. Dare to do something. Be creative. Pioneers need a work environment that inspires. In addition, they are characterised by something essential. Engagement.

BASF are committed to their employees, to giving them the opportunity to fully commit themselves. BASF want them to stand up for their tasks and projects and boost their own suggestions. At BASF, the courage to turn ideas into a new reality is promoted. For example, with BASF's best practice award, ideas programme, an event series, and the opportunity to

participate in interdisciplinary projects. This is because there is a realisation that innovative solutions for society's current and future requirements can only be found as a team.

Care and support

Taking Responsibility: We care for others.

This idea is not new - a company can only be as good as its employees. In addition, this is not just a nice theory, but also a living reality. We can only be the best team if we take the following very seriously: Care and support.

Only with excellent working conditions can we attract and retain the right employees for our company. Therefore, we promote working with and for one another. Across all job levels or professional backgrounds, and beyond national boundaries. Whether it comes to work-life balance, health or safety - we create a culture based on mutual trust, respect, and recognition in a safe and reliable work environment.

Learning and developing

Motivating People: We keep thinking.

At BASF the philosophy is that if they want to maintain their leading market position, they always have to be a bit better than their competitors. They manage that with their team. Why are they so sure? Well, according to BASF, they have a secret of success. And that means:

Learning and developing.

Daily. Together. Again and again. They want their employees to be able to develop their full potential. For themselves, for their team, and for the company. Therefore, they promote and support. They place value on independent, individual learning for each employee during daily challenges in their day-to-day work and support their employees with various development opportunities, such as qualification measures, mentoring or the structured development process. BASF say that only with further development can they ensure that they always stay one-step ahead of future market challenges, which is not only important, but also very necessary.

Source: BASF. n.d. BASF South Africa. Available at https://www.basf.com/za/en.html. [Accessed 05 October 2018].

12.7.2.1 Motivation in the workplace: A basic understanding

Employee performance in organisations is mainly determined by three things: a desire to do the job (motivation), the capability to do the job (ability) and the resources to do the job (work environment). If an employee cannot do the job, he or she can be trained or replaced (see section 12.8.4 for more information on the requirements laid down by the Labour Relations Act) and if more resources are required, the manager can rectify the problem. The problem becomes more challenging if the employee is not motivated to do the job.[35] Because of the complex nature of human beings, managers may not fully understand the problems experienced by employees and the effect of these problems on individual performance.

The level of motivation thus has a direct influence on performance, and it is important to understand how motivation takes place. However, motivation is not simply about performance. Deviant behaviour such as sabotage and absenteeism are also motivated behaviours.

Motivation refers to those forces within a person that affect his or her direction, intensity and persistence of behaviour that is within the control of the person. A motivated employee is willing to exert a particular level of effort (intensity) for a certain amount of time (persistence) towards a particular goal (direction).[36] Whereas the

emphasis in the past was on 'effort' and subsequently on ways to energise employees, the concept of **direction** is currently emphasised. It is reasoned that people will expend energy in one way or another. In a sense, employers are always competing with other forces for the time and effort of their employees. Work motivation must therefore always be looked at in the context of a rich and complex life of employees who often strive to find a work–life balance.[37]

In order to distinguish between the different approaches to motivation, the theories can be classified in terms of **content approaches** versus **process approaches:**

- **Content approaches** try to determine those things that actually motivate people to do their jobs, or the 'what' of motivation. These theories focus on the factors within a person that direct, energise, maintain or stop behaviour, and are therefore also known as **need theories**. Consequently, these theories try to identify employees' needs and the goals they want to attain in order to satisfy these needs.[38].
- **Process theories**, in contrast, try to explain the actual process, or the 'how' of motivation. According to the process theories, employees have a cognitive decision-making role in selecting their goals and the means to achieve them. These approaches are therefore concerned with trying to establish how employee behaviour is energised, directed, maintained and stopped.[39]

12.7.2.2 Content approaches to motivation

The content approaches include Abraham Maslow's hierarchy of needs, Clayton Alderfer's ERG theory, Frederick Herzberg's two-factor theory and David McClelland's learnt-needs theory. While the first three theories are based on primary instinctive needs, McClelland maintains that needs are learnt and reinforced. The different theories will now be discussed in more detail.

MASLOW'S HIERARCHY OF NEEDS

Maslow's theory of a **hierarchy of needs (five-stage model)** is one of the best-known theories of motivation. The crux of Maslow's theory is that needs are arranged in a hierarchy, often within a form of a pyramid, where the lowest-level needs are physiological needs and the highest-level needs are self-actualisation needs. In principle, lower level needs at the bottom of the hierarchy must first be fulfilled before a person can attend to higher-level needs in the hierarchy. From the bottom of the hierarchy upwards, the needs are: physiological needs, safety and security needs, affiliation needs such as love and belonging, esteem and self-actualisation needs. Maslow's five-stage model was later expanded to an eight-stage model, including three additional needs. These are the cognitive need in the fifth level (need for understanding, meaning, and predictability), the aesthetic need at the sixth level (need for appreciation and beauty) and later (1970), the transcendence need was included at the eighth level (need to assist others beyond the personal, such as service to other people and the pursuit of science). This is the highest level of motivation in the model.[40] The five-stage model will be discussed in more detail below.

At the bottom of the hierarchy are the **physiological needs**, which include food, drink, sex and air. These are the basic ingredients for survival and for biological functioning. In an organisation, these needs of employees are satisfied by the provision of things such as a salary, rest rooms, a cafeteria, heating and adequate lighting.

Safety and security needs, which include protection from physical and emotional harm, are on the next level in the hierarchy. They also include the desire for clothing, job security, pension plans, and structures in the organisation to deal with grievances and employee-assistance programmes. **Affiliation needs** include the need for friendships,

love and affection, and the need to be accepted by peers. Family and, to some extent, office parties, for example, in the workplace, satisfy this level of need.

Esteem needs include the need for a positive self-image and self-respect, and the need for recognition from others. In organisations, this need can be satisfied by means of compliments to employees, access to information, job titles and challenging job assignments.

Self-actualisation needs, which involve realising one's potential through growth and development, are at the top of the hierarchy. In an organisational context, the focus should be on providing employees with development opportunities, challenging assignments and decision-making opportunities. The focus on skills development, creativity, innovation and opportunities for challenges, for example, are regarded as part of the strategies that give South Africa's most promising companies their competitive edge. At BASF, employees are given opportunities to grow personally, thereby contributing to the organisation's success.

Maslow's theory assumes that a person attempts to satisfy the more basic needs before progressing to satisfying higher-level needs. A further assumption is that people strive to move up the hierarchy in terms of need satisfaction, and that a specific need ceases to motivate an employee once it has been satisfied. Unsatisfied needs cause stress, frustration and conflict within an individual, and also between individuals. Management can help employees to satisfy needs at various levels by promoting a culture wherein, for example, self-esteem and self-actualisation needs can be satisfied. The opportunity of participation in decision-making about work and the provision of learning opportunities are examples of self-actualisation opportunities.

Although it is a very popular and convenient theory to apply, Maslow's theory has many shortcomings for use in the workplace as it oversimplifies matters. The idea that all needs originate intrinsically, for example, is questionable. Needs are often learnt and develop because of social influences (see McClelland's theory) and different life experiences. Esteem needs, for example, might be desirable because we see the positive effects esteem has on others. Research has shown that not all levels of needs as identified by Maslow are always present, and certain cultures may have different need categories and hierarchies. Some people, for example, are motivated mainly by money, while others mainly want to satisfy their social needs at work. Employees may also satisfy their needs outside the workplace, making it difficult for managers to determine the genuine levels of motivation at work. Finally, it is also not the case that highly satisfied employees are always highly productive.[41] With reference to the BASF case study, it is clear that the company ensures that different levels of motivations are addressed through various programmes, thereby appealing to the diverse needs of employees.

ALDERFER'S ERG THEORY

Alderfer's theory represents a refinement of Maslow's five-level hierarchy in that, according to Alderfer, there are three core needs: existence, relatedness and growth (ERG). These needs can be summarised as follows:[42]

- **Existence needs**. These needs relate to a person's basic, material, existence needs. These needs correspond to Maslow's physiological and safety needs.
- **Relatedness needs**. These needs concern a person's desire for interpersonal relationships and interaction. They are similar to Maslow's affiliation/social needs and the external aspect of Maslow's esteem needs.

- **Growth needs.** These relate to the desire of an individual to make a creative or productive contribution. They are similar to Maslow's esteem and self-actualisation needs.

The ERG theory does not subscribe to a rigid hierarchy of needs, whereas Maslow maintained that a lower-level need must first be satisfied before a higher-level need may be pursued. According to the ERG theory, two or even all three need categories can influence behaviour simultaneously. The ERG theory also suggests that if a person is continually frustrated in his or her attempts to satisfy growth needs, relatedness needs re-emerge as a major motivating force, and this may force the person to redirect efforts towards satisfying a lower-order need category. The implication is that, for example, employees' demands for higher pay or better benefits may occur because of a stifling work environment. Alderfer's theory is also visible in BASF's efforts to motivate its employees through creating a conducive and empowering work environment. BASF believes in agile working, and opportunities to participate in interdisciplinary projects as a team. This is clearly an example of how the environment is crafted by the employer to be more attractive, thereby increasing employee motivation to be productive.

HERZBERG'S TWO-FACTOR THEORY AND JOB ENRICHMENT

Frederick Herzberg proposed a motivational model called the **two-factor model**, which consists of maintenance and motivational factors:

- The **maintenance (hygiene) factors** do not act as motivational factors, but if they are absent in an organisation, this could have a negative effect on employee morale. The maintenance factors are those aspects that people consider essential to do any job, for example, organisational policy and administration, equipment, supervision, interpersonal relationships with colleagues and supervisors, salary, status, working conditions and work security. In summary, these factors are thought of as extrinsic conditions and are controlled by someone else.[43]
- **Motivational factors**, also called **growth factors**, are focused on the content of the job. They include aspects such as achievement (successful completion of tasks), recognition for what has been achieved, the job itself (meaningfulness and challenge), progress and growth, responsibility and feedback. Motivational factors are benefits over and above the normal job to be done, which tend to increase employee satisfaction because employees get more out of the normal job they do. When motivational factors are present, these are likely to motivate employees to achieve higher productivity, to be more committed to their jobs, and to find creative ways of accomplishing both personal and organisational goals.[44]

Motivational or growth factors are also present in how BASF motivates its employees. An example is where their employees are encouraged to take advantage of development opportunities, where they are given sufficient room to succeed and grow, as well as the directions that are mapped out in which employees may pursue a career within BASF. In this way, the organisation supports the individual's personal goals, but also motivates employees towards achieving the organisational goals.

Table 12.1: Comparison of the theories of Herzberg and Maslow

	Herzberg	Maslow
Motivational factors	•Recognition •Status	•Esteem needs

	•Advancement	
	•Work itself •Responsibility	•Self-actualisation
Maintenance factors	•Social network •Supervision	•Social/belongingness
	•Policy/administrative	•Safety and security
	•Job security •Salary •Working conditions	•Physiological

As shown in Table 12.1, Herzberg's theory can be linked to Maslow's hierarchy of needs. The maintenance (hygiene) factors are similar to the lower-level needs in the hierarchy, while the motivators are the same as the higher-level needs.

According to Herzberg's theory, a distinction can be made between internal motivation (based on motivators) and external motivation (based on maintenance factors):

- **Internal motivation**. This motivation originates from the satisfaction that occurs when a task is executed, or a duty is performed. For example, if a teacher enjoys teaching children, the activity is in itself rewarding and the teacher will be self-motivated. The intrinsic rewards of the job motivate some people more than external influences such as money and trophies do. Herzberg's theory of motivation emphasises that jobs should be enriched to provide opportunities for growth and more responsibility. Compare the strategies of the most promising companies we have mentioned regarding the use of internal motivation. More frequently, organisations find that employees want more responsibility and meaning attached to what they are doing. This speaks to internal motivation and is seen in the BASF case study, where employees are given stretch assignments and interdisciplinary projects to ensure that they are meaningfully engaged.
- **External motivation**. In contrast to internal motivation, external motivation usually involves action taken by a third party. Here, a person is motivated because he or she anticipates that a reward of some kind (for example, money, awards or feedback about performance) will be given. Incentives such as profit-sharing, bonuses and awards are used by organisations to instil certain work habits that are beneficial both for the organisation and the individual. Unfortunately, external rewards are not enough to motivate people in the long term. Organisations should therefore focus on a combination of both internal and external rewards. They should keep employees motivated by ensuring that they experience job satisfaction (because they find their work challenging) and have an appropriate number of external awards. Although internal motivation is important, external motivation also plays a critical role in contributing to employee satisfaction.

An important contribution of Herzberg's theory is his emphasis on the task itself as the source of job satisfaction. **Job enrichment** as a way to design jobs is therefore a valuable practical application of his theory. It entails incorporating, by means of vertical loading (giving employees responsibilities that are usually allocated to senior employees to give them more control over aspects such as work-scheduling, cost control and work methods), the opportunity to experience achievement, recognition, stimulating work, responsibility and advancement in a job.

Most of the critiques of Herzberg's theory centre on the motivational role of lower-order needs, especially the role of money. Although money can be useful for facilitating acceptance of organisational change, research suggests that manual workers are more likely to be motivated by money than more professional or managerial groups are. More recent research, however, indicates that lower-order factors such as pay and job security are not mentioned as either satisfying or dissatisfying by participants. The role of money is therefore still uncertain, though it may seem that the different needs for money by different employees or groups of employees are not taken into account by Herzberg's theory.[44] It is, however, interesting to note that although neither Maslow nor Herzberg cites money as a significant motivator, many organisations still use financial incentives as their primary motivational tool.

MCCLELLAND'S THEORY OF NEEDS

The theories we have mentioned above focus on primary instinctive needs. According to McClelland's theory, however, needs are learnt and reinforced. This theory focuses on three needs that explain motivation:[46]

- **Need for achievement (nAch)**. This is a need to excel, to be successful or to exceed a set standard.
- **Need for power (nPow)**. This is a need to be influential, to control others or to make others behave in a way they would not otherwise behave.
- **Need for affiliation (nAff)**. This is the need for warm and close interpersonal relationships, and to be liked and accepted by others.

Given the many needs of employees listed above, managers have the challenge of determining the dominant need of their employees and of offering opportunities in which these needs can be met. Knowledge about the motivational role of needs can be useful during the selection and placement process. For example, research has found that employees with a high need for power (nPow) and a low need for affiliation (nAff) make good managers, and that people with a high need for achievement (nAch) generally make successful entrepreneurs.

As needs can be learnt, according to this theory, employees can also be trained to increase their achievement motivation. Managers should also create challenging goals or tasks because the need for achievement is positively correlated with goal attainment, which, in turn, influences performance.

Although maintenance factors are not regarded as unimportant, a critical evaluation of the most promising companies will highlight the importance of motivators such as providing recognition, challenges, opportunities for development and growth, and responsibility. Managers have to take care of maintenance factors, but if they really want motivated employees, they should create opportunities for their employees to experience internal motivation. Managers should thus be careful not to rely too much on maintenance factors or external forms of motivation. BASF shows a balance of internal and external forms of motivation through addressing both the need for meaningful and engaging work assignments.

12.7.2.3 Implications of content-based approaches

The four content theories discussed above attempt to explain behaviour[47] based on the needs of employees. Firstly, these theories suggest that needs change. Different employees have different needs at different times. For example, a job with a high salary but without security might motivate a young person, but be unacceptable to someone in his or her forties for whom job security is more important. Similarly, more holiday time may be desired near retirement age than earlier in life. The recommendation for

management is to offer employees a choice of rewards in order to fulfil the different needs.

Secondly, managers need to balance the power need (competition) with the affiliation need (co-operation). It is possible to offer rewards that support both individual achievement and teamwork, for example. Managers also need to support achievement needs by providing opportunities for growth – for example, by providing novel tasks or experiences. Lower-order needs should also be taken care of by minimising unnecessary threats to personal safety, well-being and social relationships.

Thirdly, needs may be unconscious. Most people are not fully aware of the inner needs and drives that influence their behaviour.

The desire of an employee to win the 'salesperson of the month' trophy, for example, may be due to an unconscious feeling of inadequacy, and this would be a way of proving himself or herself.

Needs are, therefore, often inferred. However closely one may observe the behaviour of a colleague, it is possible only to draw conclusions (inferences) about which motives have actually caused the behaviour. It is sometimes very difficult to understand the real motives underlying certain behaviour. For this reason, it is important that managers discuss with employees the things that motivate them. This allows managers to make suggestions about changes that can be made in order to meet the needs of employees more adequately.

Lastly, content-based approaches warn managers against relying too much on financial reward as a source of employee motivation.[48]

12.7.2.4 Process approaches to motivation

The difference between content and process theories has already been discussed. Process approaches try to identify the process by which factors influence motivation. The three most common process theories are the expectancy theory, equity theory and goal-setting theory. These three theories are discussed below.

EXPECTANCY THEORY

According to Victor Vroom's **expectancy theory**, motivation depends on two aspects: how much we want something and how likely we think we are to get it. There are four assumptions upon which the expectancy theory rests:

1. Behaviour is a combination of forces controlled by the individual and the environment.
2. People make decisions about their own behaviour in organisations.
3. Different people have different needs, goals and desires.
4. People will act in a certain way, and the tendency to act in a certain way depends on the strength of the expectation that the action will be followed by a given outcome and the degree to which the person desires the outcome.

Three key concepts in the theory are expectancy, instrumentality and valence:

1. **Expectancy** refers to a person's belief that a certain level of effort will lead to a particular level of performance (effort → performance expectancy). Factors such as a person's self-esteem, previous success, support from others, access to information and self-efficacy (see the section entitled 'Goal-setting theory and feedback' on page 395) will influence his or her expectancy perceptions.
2. **Instrumentality** refers to the strength of a person's belief that a certain performance will lead to a specific outcome (performance → outcome expectancy).

3. **Valence** (desirability) refers to the attractiveness or anticipated satisfaction or dissatisfaction that the individual feels towards the outcome. It is determined by the person's perceptions about how much the outcome will fulfil or interfere with his or her needs.

The example in the box that follows illustrates this process.

Research indicates that the expectancy theory is able to predict employee motivation in different cultures.[49] Critics of the theory, however, argue that, as a rational theory, it does not fully acknowledge the role of emotions in employee effort and behaviour.

Some of the most important implications of the expectancy theory for management are as follows:

- Managers are advised to enhance effort → performance expectancies by assisting employees to accomplish their personal goals. They can do this by providing support, coaching, training and development, and also by increasing employees' self-efficacy. Self-efficacy refers to a person's belief that he or she has the ability to complete a task successfully. Managers should focus on linking performance to rewards that are valued by employees.
- Attempts should also be made to link personal goals to organisational goals. South Africa's most promising companies, for example, encourage creativity and innovation, and provide many opportunities for challenges, as long as the end result is added value to the clients and the business.

EQUITY THEORY AND ORGANISATIONAL JUSTICE

The crux of the equity theory advanced by Stacey Adams is that employees compare their efforts and rewards with those of other employees in similar situations. This theory is based on the assumption that people are motivated by the desire to be treated equitably in the workplace. A state of equity exists when one employee's input–outcome ratio compared with that of another employee in a similar position is equal. In contrast, if input–outcome ratios are unequal, inequity is said to exist, with the result that the person will perceive the situation as unfair and therefore be motivated to do something else. Various means can be used to restore equity after equity tension has been experienced:[50]

- The employee may change inputs.
- The employee may change outputs.
- The employee may change his or her attitude.
- The employee may change the person with whom he or she compares himself or herself.
- The employee may leave the job.

Despite the research that supports this theory, certain aspects remain unclear – for example, how employees deal with conflicting equity signals, and how inputs and outputs are defined. Motivation is also not only influenced by direct monetary rewards, but by indirect monetary rewards as well (see Section 12.6.2). Another problem is that the theory incorrectly assumes that people are only rational, individualistic and selfish. Equity theory does, however, provide an important insight into employee motivation, and every manager should take note of its implications.

The role of equity theory has been expanded to develop the concept of **organisational justice**. One of the lessons learnt from the equity theory is that employers continually have to treat their employees fairly in the distribution of

rewards.[51] Organisational justice reflects the extent to which employees perceive that they are treated fairly at work. It consists of three components:

Expectancy theory: An example

Imagine that a company wants to use the expectancy theory to determine whether Thabisa, a sales representative, will be motivated to promote the products of that company.

- **Expectancy** refers to Thabisa's belief that a certain level of effort will lead to a particular level of performance (effort → performance expectancy). Thabisa may have the expectancy that if she works hard on promoting products, sales targets will be met (performance). If she has zero expectancy that the effort will lead to performance (in terms of meeting the sales targets), she will most probably not promote the products. Factors such as Thabisa's self-esteem, previous success, support from others, access to information and self-efficacy will influence her expectancy perceptions. We assume Thabisa is of the opinion that her effort will most probably lead to performance.
- **Instrumentality** refers to the strength of Thabisa's belief that a certain performance will lead to a specific outcome (performance → outcome expectancy). This belief is probably based on learning from previous experiences, and the outcome refers to outcomes that are important at a specific time. Thabisa believes that meeting the sales target will lead to promotion to a managerial role. Her belief is based, among other things, on the current practice in her company.
- **Valence** (desirability) refers to the attractiveness or anticipated satisfaction or dissatisfaction that Thabisa feels towards the outcome. It is determined by her perceptions about how much the outcome will fulfil or interfere with her needs. Thabisa has strong power needs that can be fulfilled in a managerial role, making promotion to a managerial role very attractive.

Based on this discussion, it seems clear that Thabisa will most probably put in a big effort to promote the products of the company, as this may fulfil her needs. With reference to the BASF case study, employees' preferences with regard to goals, career pathing and work environment are supported, thereby leading to enhanced employee motivation through a congruence between the organisation's goals and the employee's expectations.

1. **Distributive justice**, referring to the perceived fairness of how resources and rewards are distributed or allocated.
2. **Procedural justice**, defined as the perceived fairness of the process and procedures used to make allocation decisions.
3. **Interactional justice**, referring to the quality of the interpersonal treatment people receive when procedures are implemented.[52]

Equity theory has many practical implications for management, including the following:[53]

- Employees are powerfully motivated to correct the situation when their perception of fairness is offended. Accordingly, the best way to manage job behaviour is to understand underlying processes.
- The theory emphasises the need to pay attention to the perceptions of the employees of what is fair and equitable, and not to how fair management think its policies, procedures and reward systems are. Managers are thus encouraged to make hiring and promotion decisions on merit-based job-related information.
- Because justice perceptions are influenced by the extent to which management explains its decisions, it is important that management communicates the rationale behind decisions.
- Employees should participate in making decisions about important work outcomes. Research indicates that employees are more satisfied with their performance appraisals and resultant outcomes if they have a say.

- Employees believe that they are treated fairly if they have the opportunity to appeal against decisions that affect their welfare.
- Employees are more likely to accept and support change when they believe it is implemented fairly and when it produces equitable outcomes.
- Teamwork can be promoted by treating employees fairly.
- Employees who are denied justice are more likely to turn to litigation than employees who are given access to justice.
- Managers need to entrench values such as honesty, integrity, open communication and transparency as part of corporate governance.

GOAL-SETTING THEORY AND FEEDBACK

Goal-setting theory is built on the assumption that, all things being equal, the performance of employees will improve if they strive towards a definite goal. Goal-setting has motivational value because goals not only direct attention, but also regulate effort (motivate employees to act), increase persistence and foster the development and application of task strategies and action plans.[54]

The thrust of goal-setting theory is that the more difficult the goal is, the higher the level of performance is if employees are committed to the goals. Obviously, when goals are set, the person concerned must be capable of achieving those goals. Furthermore, research has shown that setting specific goals leads to higher performance for simple tasks than for complex tasks. This theory also presupposes that an employee will be committed to a goal if the goal has been negotiated between the employee and the organisation.

Another important factor is feedback. Providing feedback to employees most probably leads to the improvement of their performance. Goals inform employees about performance standards and expectations so that they can channel their energies accordingly. In turn, feedback provides information needed to adjust effort, direction and strategies for goal accomplishment. Management can give effective feedback by utilising the following principles:[55]

- Give feedback immediately.
- Evaluations should be descriptive. They should describe what was done well and why.
- The focus should be on behaviour and not on personality.
- Feedback should be specific and not general (components of performance and not performance as a whole).
- Feedback should be directed at behaviour that can be changed.
- Development activities should be agreed upon.

In the BASF case study, it is seen that if the company does well in meeting its goals, it means that employees have contributed exceptionally towards these goals.

The concept of **self-efficacy** is also central to the goal-setting theory. It refers to the belief in one's capacity to perform a specific task to reach a specific goal. The concept is based on the work of Albert Bandura, who proposed that motivated behaviour involves a cycle of setting challenging goals, monitoring success at meeting these goals, taking actions to reduce any discrepancies between the goal and the outcome, then setting new and more challenging goals, starting the cycle all over again. Self-efficacy can be increased by applying the following approaches:[56]

- Provide guidance and support to the employee, increasing the likelihood that he or she will experience success when performing a challenging task.

- Provide successful role models (mentors) who have already mastered a similar task.
- Be a targeted ‘cheerleader’ emphasising the employee’s knowledge and ability.
- Reduce stress in the environment that is unrelated to the challenging task.

12.7.2.5 Implications of process-based approaches

Most modern approaches to work motivation are based on process theories. Process-based theories have some predominant themes that are important for our understanding of work motivation:

- Firstly, intention plays a key role in motivated behaviour, with a goal as the most common form of that intention. These goals are associated with anticipated happiness or unhappiness.
- Secondly, the concept of feedback is of critical importance.
- Thirdly, process-based theories all have a rational element, with employees critically gathering and analysing information.
- Fourthly, the theories also include some form of self-assessment. Employees tend to take stock of where they are, compared to where they want to be. This is possible when the organisation supports the employee through his or her career trajectory. The BASF case study shows that the organisation supports the employee with the numerous directions in which he or she would like to pursue a career.
- Lastly, a non-rational component is also important in some of the most recent approaches. This element may be values, culture or the feeling that arises from the self-efficacy belief.[57]

12.7.3 Employee motivational strategies

Employees need to be better motivated not only to improve organisational effectiveness, but also to provide a better quality of life for all employees. Possible broad motivational strategies to improve employee motivation are briefly discussed below. Whereas the implications for management of the different theories have already been discussed, most of the following strategies are applied on macro- or organisational level:[58]

- **Job design**. Employees place a high value on jobs that provide satisfaction, are challenging, provide growth and allow adequate achievement opportunities. Jobs can be redesigned to make them more challenging by using job rotation, job enlargement or job enrichment. Job rotation allows employees to move through a variety of jobs, functions or departments. Job enlargement focuses on expanding an employee’s duties and/or responsibilities, and job enrichment allows jobs to become more desirable and challenging by including new and more difficult tasks and granting an employee more accountability. Other aspects to consider are variable work schedules, flexible work schedules, job sharing and telecommuting.
- **Employee involvement programmes such as participative management and quality circles**. Employee involvement is a participative process that uses the entire capacity of employees to encourage commitment to the organisation’s success. Employees are given autonomy and control in making decisions about their own work (see the influence of content theories, especially the theory of Herzberg and expectancy theory). Quality circles are work groups that take over the responsibility from management for solving quality problems. They generate and evaluate their own feedback, while management retains final control regarding the implementation of recommendations.

•**Management-by-objectives (MBO) strategies**. MBO strategies are closely related to the goal-setting theory and comprise cascading of organisational objectives down to individual objectives. Goals and ways of measurement, as well as specific time frames for completion, are jointly determined and feedback on performance is given.
•**Intrapreneurial incentives**. New ideas from employees can be developed within organisations with the financial support of the organisation. Such programmes are known as intrapreneurship, which encourages employees to come up with new suggestions and ideas.
•**Training and education**. Learning opportunities can be a strong motivational force since they are critical to individual growth and opportunity. This is evident in the BASF case study. A career at BASF means that the individual can achieve goals both professionally and personally. Organisations that invest in the training and development of employees are generally more successful. In South Africa, opportunities to invest in the training and development of employees have been created by means of the Skills Development Act (No. 97 of 1998) and the Skills Development Levies Act (No. 9 of 1999)(see Section 12.8.2). Providing opportunities for skills development and transfer of knowledge, for example, is regarded as an important strategy that contributes to South Africa's most promising companies' competitive edge.
•**Employee-recognition programmes**. Recognition for above-average work performance is widely used to drive results in organisations. Employee recognition programmes vary from cash, shares, profit-sharing, overseas visits and bonuses to trophies and certificates.
•**Empowerment programmes**. Empowerment is an important method of enhancing employee motivation. Empowerment is the process of enabling employees to set their own goals, make decisions and solve problems within their sphere of responsibility and authority.
•**Reward systems**. A basic management tool to motivate employees is the organisation's reward system. A reward system is directly related to the expectancy theory of motivation, and the effect of the reward system on attitudes and employee behaviour should be fully investigated.
•**Career management**. Career management and development is the path that an employee identifies and follows in order to achieve his or her aspirations. Employees will be better motivated if they are personally involved in decision-making about possible career options open to them than if they are not involved. This personal involvement therefore leads to a better-motivated human resource planning. Employees will have been empowered in being assisted by an organisational career management team to face challenges and make decisions that benefit both the individual and the organisation (see McClelland's theory of needs).
•**Employee engagement**. Many employees have an inherent need to contribute to an organisation and in most situations, their needs and that of the organisation can be filled simultaneously. Employee engagement is a heightened emotional and intellectual connection that an employee has for the organisation they work for and which influences them to apply extra effort in the workplace (see BASF case study).

Critical thinking

What is your level of motivation?

A motivated employee has been described as someone who is willing to exert a particular level of effort (intensity) for a certain amount of time (persistence) towards a particular goal (direction). Now, reflect on a personal experience (or that of someone known to you) that had a positive or a negative impact on your level of motivation (not a specific need that was satisfied or not). Try to remember the process that influenced your (or the person's) level of motivation. What happened? Who was involved? What were the outcomes? How did you or the person feel? How did the experience influence your or the person's behaviour?

The following questions may help you to reflect on the experience:

1. Was it related to effort you or the person put in, but that did or did not materialise in worthwhile results?
2. Was it an experience of fairness or unfair treatment in comparison with that of other employees or people?
3. Was the experience related to the setting of and accomplishment of very clear goals?

Now that you have reflected on the experience, identify the motivational theory most relevant to that experience.

All three questions represent different process approaches to motivation discussed in this section: the expectancy theory (1), the equity theory (2) and the goal-setting theory (3). They are all based on a specific process, or the 'how' of motivation. The relevance of the different theories for different people under different circumstances is clear. Can you summarise the relevance of applying these theories in the workplace?

12.8 Labour legislation that has an impact on the workplace

12.8.1 Introduction to labour legislation

Several different environmental factors influence the way an organisation's human resources are managed. One such factor is the legal environment and, in particular, those laws that are applicable to people in organisations. Legal issues affect almost all aspects of human resource management, including dismissal, retrenchment, discrimination and retirement. The impact of legal rules is so complex that line managers and human resource professionals should have a good working knowledge and understanding of these laws. At times, legal expertise is required to solve workplace problems or to take legal aspects further, but in most cases, legal matters can be solved independently by line managers and/or human resource professionals. The management of human resources is a more complex matter than the simple application of various laws, but without a basic knowledge of the most important labour laws, organisations may find themselves with more people problems than anticipated. Readers must take note that labour legislation laws are amended from time to time. Consult the government printer (www.gpwonline.co.za) for the latest amendments.

The case study that follows provides an illustration of labour-law issues in the workplace.

CASE STUDY: Labour law issues in the workplace: *Duncanmec (Pty) Limited v Gaylard NO and Others*, 2018

Duncanmec is a manufacturing company specialising in the design and manufacture of truck-mounted equipment, based in Alberton, Gauteng. The company employees, who are members of a union, embarked on an unprotected strike at the employer's premises in Alberton, during which they danced and sang struggle songs. The song was sung in Isizulu, and the lyrics were translated as, 'climb on top of the roof and tell them my mother is rejoicing when we hit the boer'.

The employer, Duncanmec (Pty) Limited (Duncanmec) reacted by issuing an ultimatum calling upon the employees to end the strike and resume work. The employees failed to heed the ultimatum. The employees were subsequently charged with two counts of gross misconduct for singing racial songs in an offensive manner while on duty; participating in unlawful strike action; and continuing to do so while defying management's lawful instruction to return to work. Duncanmec initiated the disciplinary hearing, which was chaired by an external independent chairperson. The chairperson concluded that the singing of the song and dancing amounted to racism and that even though Duncanmec's code did not make it dismissible, the charge relating to racism was so serious as to warrant dismissal. Nine employees were found guilty as charged and dismissed following a properly constituted disciplinary hearing. The chairperson relied on video evidence and issued final written warnings to other employees for participating in an unprotected strike.

The union challenged the procedural and substantive fairness of the dismissal in the Bargaining Council on behalf of the employees. The arbitrator found that the singing of the song, particularly within the context of a workplace, was inappropriate but did not constitute racism. The arbitrator reasoned that a differentiation between singing the song and referring to someone using a racist term needs to be drawn. The reason for this was because the song is a struggle song and has a history to it. The employees were reinstated but to show her disapproval of the singing of the song, the arbitrator limited their compensation to three months. The company was not satisfied with the award and took it on review to the Labour Court. In the Labour Court, Duncanmec argued that the singing of the song constituted hate speech and racism and therefore the sanction of dismissal was justified. The union disagreed with Duncanmec's argument and contended that the song was an old struggle song, which was sung by workers from the apartheid era to show defiance of the authority of the employers in the context of the strike. The union further argued that the strike was non-violent. The application for review of the award was dismissed by the Labour Court and the Constitutional Court finally heard the appeal after the Labour Appeal Court dismissed application for leave to appeal by Duncanmec. The Constitutional Court granted leave to appeal but dismissed the appeal and thereby confirmed the arbitrator's finding that the song was inappropriate but did not constitute racism. The court pointed out that there is no principle in our law that requires a sanction of dismissal will automatically follow in any case involving racism. The court concluded that the unprotected strike was non-violent, peaceful and short-lived and that the employees had no prior disciplinary records.

Racism in the workplace is a cancer and a serious matter, but it will not always constitute a dismissible offense. The court reiterated the principle that commissioners, arbitrators and court jurists should deal with racism fairly but firmly, to eliminate racial discrimination and promote human rights. In conclusion, this means that each case will be determined on its own merits considering the context in which the offence of racism occurs.

SOURCE: Southern African Legal Information Institute. *Duncanmec (Pty) Limited v Gaylard NO and Others*, 2018. Available at http://www.saflii.org/za/cases/ZACC/2018/29.pdf.

12.8.2 The Constitution of the Republic of South Africa, 1996

The Constitution of 1996 is the supreme law of the Republic of South Africa; any piece of **legislation** in South Africa or conduct inconsistent with it is invalid. As its name implies, it sets out the structure of the state.

It provides for the legislature (parliament), the judiciary (the courts of law) and the executive (national, provincial and local government) arm of state. When it comes to the courts, the Constitution of 1996 provides that the Constitutional Court is the highest court in respect of constitutional matters (this means that the Constitutional Court is the highest court that can hear a matter relating to, for instance, an infringement of fundamental rights). But when it comes to human resource management, the most important part of the Constitution of 1996 is the Bill of Rights (Chapter II).

The Bill of Rights protects a number of important fundamental rights. Section 23 of the Constitution of 1996 relates specifically to labour rights.

Everyone has the right to fair labour practices, for example, employers and trade unions have the right to organise and bargain collectively. Employees have the right to join a trade union of their choice (this is called freedom of association) and provision is made for the right to strike.

But it is not only these fundamental labour rights that have a direct impact on the workplace: other rights are as important. Section 9 of the Constitution of 1996 provides that no one may be discriminated against unfairly and section 22 protects the right to choose a trade, occupation or profession freely.

The fundamental human rights contained in the Bill of Rights are formulated in a wide and general way. In most cases, specific pieces of legislation give further effect to these rights. In this way, the Labour Relations Act (No. 66 of 1995) gives effect to the fundamental labour rights contained in section 23 of the Constitution of 1996. Section 23(1) of the Constitution gives everyone a right to fair labour practices. The Labour Relations Act (No. 66 of 1995) (the LRA) was enacted to give effect to labour rights guaranteed by section 23 of the Constitution. Section 185 of the LRA protects employees against unfair dismissal and unfair labour practices. Every employee has a right not to be unfairly dismissed or to be subjected to unfair labour practices. The Employment Equity Act (No. 55 of 1998) was enacted in terms of section 9(4) of the Constitution to give effect to the right not to be unfairly discriminated against in the workplace, guaranteed in section 9(3) of the Constitution.

The most important recent development relates to the right to fair administrative action, enshrined in section 33 of the Constitution of 1996. Again, this fundamental right has its own specific piece of legislation: the Promotion of Administrative Justice Act (No. 3 of 2000). One of the important questions that has arisen is whether the dismissal of a public sector employee in the public service (where the state is the employer) constitutes an administrative action in terms of the Promotion of Administrative Justice Act. It seems that South African courts are now tending towards the view that workplace issues in the public service, especially dismissal of a public-service employee, must comply with the provisions of section 23 of the Constitution of 1996 as given effect to by the Labour Relations Act, and not the Promotion of Administrative Justice Act. Section 185 of the Labour Relations Act constitutes a legislative scheme for giving effect to the right not to be unfairly dismissed for both public and private sector employees.

Another important point in respect of fundamental rights is that none of these rights are absolutely unlimited. Section 23 of the Constitution of 1996 provides for a right to strike, but the Labour Relations Act places certain limitations on this right. Employees engaged in essential services, for example, may not strike. Furthermore, the Labour Relations Act also imposes a number of procedural requirements for strikes to be lawful and protected.

12.8.3 Laws affecting business activities

Many laws affect business activities in South Africa. Laws of this nature are found in most countries. There are laws to regulate the form and functioning of businesses, such as the Companies Act (No. 71 of 2008). There are laws that provide for various forms of tax, ranging from value-added tax and income tax to company tax. There are laws dealing with intellectual property (copyright and trademarks), laws dealing with insolvency and even some laws dealing with specific forms of contracts. This means that

the labour laws are just one set of laws a business has to take into account. Many other laws impose direct or indirect duties or obligations on a business.

When it comes to the management of people in organisations, the most important pieces of legislation are the Labour Relations Act (No. 66 of 1995) (usually simply referred to as the LRA) and the Basic Conditions of Employment Act (No. 75 of 1997) (the BCEA). Other important laws include the Employment Equity Act (No. 55 of 1998) and other laws relating to skills development and workplace health and safety. The sections that follow look briefly at the most important of these laws.

In some cases, it may be necessary to look at the entire piece of legislation. Most human resource managers have a copy of the LRA on their desks. Because the labour laws are changed (amended) from time to time, it is important to ensure that a manager refers to the correct version of the legislation.

The discussion of the acts given in this chapter is brief. If further information about these acts is required, it is probably better to study the specific act in its entirety. Copies may be obtained from the Government Printer and bookshops.[59]

12.8.4The Labour Relations Act (No. 66 of 1995) (LRA)

12.8.4.1Background

Since the first democratic election in South Africa in 1994, the labour dispensation has changed significantly. Organised labour has played an important role in South Africa's transformation process. Not only do workers, through their trade unions, play a key role in the redistribution of wealth through collective bargaining over wages, but they are also instrumental in the broader socio-political process of transforming South African society. Consequently, the system of labour relations in South Africa has seen tremendous changes. For example, a new Labour Relations Act was introduced in 1995. A new Basic Conditions of Employment Act and a new Employment Equity Act were introduced in 1997 and 1998 respectively. Before 1994, labour legislation was made and brought into effect by government alone, in terms of the now repealed Labour Relations Act (No. 28 of 1956). The process leading up to the passing of the LRA was therefore unique. For the first time, labour legislation represented basic consensus or agreement between organised labour, organised business and the state.

The implementation of sound labour relations in businesses not only ensures fair labour practices, but also contributes to organisational success. **Labour relations**, from a business-management point of view, may be described as a complex system of individual and collective actions as well as formal and informal relationships that exist between the state, employers, employees and related institutions concerning all aspects of the employment relationship.

Relationships in a business are considered to be a crucial element in labour relations. More attention is given to the different parties in the labour relationship in the next section.

The parties involved in the labour relationship are the employer and employee as primary parties, and the state as a secondary role-player. The state's role is to provide, by means of legislation, a framework within which the primary parties can conduct their relationship. Figure 12.3 illustrates this tripartite relationship.

Basically, employees in managerial positions represent the interests of the owners of businesses in the workplace.

In the private sector, this essentially means safeguarding and improving the profitability of businesses.

The state's primary role is, as stated, to provide the framework or infrastructure within which labour and management can conduct their relationship. A trade union is a voluntary association created by workers to protect themselves at work, to improve their working conditions through collective bargaining, to better their quality of life and to provide a means of expressing their views on issues in society.

The Labour Relations Act has been amended several times. It is important to note that the Labour Relations Amendments Act (No. 6 of 2014) addresses the problem of labour broking; regulating contract work; provisions that deal with the operations of the CCMA to facilitate the resolution of disputes and enhance the efficiency of the CCMA's operations; enforcing of arbitration awards; review applications in the Labour Court; procedural requirements for protected industrial action; essential services; and organisational rights and collective bargaining. The Labour Relations Amendment Bill (No. 8 of 2018) provides criteria before the minister can extend a collective agreement, to provide for the renewal and extension of funding agreements, to provide for picketing by collective agreement, to extend the meaning of 'ballot' and to provide for the advisory arbitration panel. (Refer to www.gpwonline.co.za for the latest information).

Figure 12.3: Participants in labour relations

12.8.4.2 The contents of the LRA[60]

In day-to-day human resource management, the LRA is the single most important piece of legislation, especially because it contains the rules relating to dismissal of employees. But it is worth repeating that the LRA gives effect to all the fundamental rights contained in section 23 of the Constitution of 1996 and it therefore deals with a large number of issues. It is wide in scope, which explains why the LRA is so long (there are 214 sections in the LRA and numerous schedules). The purpose of the LRA is set out in section 1, including giving effect to and regulating the fundamental rights contained in the Bill of Rights and providing a framework within which employees, their trade unions, employers and employers' organisations can engage in collective bargaining and formulate industrial policy. The purposes of the LRA also include the promotion of orderly collective bargaining and the effective resolution of labour disputes.

The LRA applies to all employees and employers, but members of the South African National Defence Force, the National Intelligence Agency, the South African Secret Service, the South African National Academy of Intelligence and Comsec are excluded from the operation of the LRA. Comsec, or Electronic Communications Security (Pty) Ltd, was established by the Electronic Communications Security (Pty) Ltd Act (No. 68 of 2002).

FREEDOM OF ASSOCIATION

Freedom of association means that employees have the right to form a trade union or to join a trade union of their choice. They also have the right to participate in the lawful activities of a trade union. The protection of freedom of association in the LRA must be seen within the context of the fundamental right of freedom of association contained in section 23 of the Constitution of 1996. Employers have a similar right: to form or to join an employers' organisation. These rights of association (the foundation of the notion of

collectivism) are recognised in most modern labour-relations systems and they are also enshrined in the international labour standards of the International Labour Organisation (ILO).

ORGANISATIONAL RIGHTS

Trade unions may apply for and exercise certain organisational rights in respect of the employer's premises or the employer's operations. Provision is made for the trade union to gain access to the employer's premises to recruit members, to communicate with members or to represent members' interests. Unions may hold meetings at the employer's premises after hours. This organisational right is not unlimited, of course: the union's right to gain access to the employer's premises may be subject to conditions regarding time and place that may be necessary 'to safeguard life or property or to prevent the undue disruption of work'. The right of access to the employer's premises is just one of a number of organisational rights provided for in the LRA. Other organisational rights include time off for trade union activities, the right of a trade union to have trade union dues or subscriptions deducted from employees' wages or salaries, and the right of a trade union to information it needs when consulting or negotiating with the employer.

BARGAINING AND STATUTORY COUNCILS

Large parts of the LRA focus on collective bargaining. Bargaining councils are bargaining and dispute-resolution structures introduced by the Act. They are centralised at sectoral level. One or more registered trade unions and one or more employers' organisations may form a bargaining council. The union and the employers' organisation agree to the council's constitution and the council is then registered.

The powers and functions of bargaining councils include:

- the conclusion of collective agreements;
- the enforcement of collective agreements;
- the prevention and resolution of labour disputes;
- the performance of dispute functions set out in the Act;
- the establishment and administration of a fund to be used for resolving disputes;
- the promotion and establishment of training and education schemes;
- the establishment and administration of funds related to pension, provident, medical aid, sick pay, holiday, unemployment schemes, or other schemes or funds for the benefit of one or more of the parties to the bargaining council or their members;
- the determination, by collective agreement, of the matters that may not be an issue in dispute for the purpose of a strike or lock-out at the workplace; and
- the consideration of workplace forums or additional matters for consultation.

A representative trade union (or more than one), combining forces with members who constitute at least 30 per cent of the employees in a sector, or one or more employers' organisations, may apply to the Registrar (Department of Labour – see footnote page 412) for the establishment of a statutory council in a sector or area in which no bargaining council is registered. The difference between a **bargaining council** and a **statutory council** lies in the fact that a bargaining council is established by agreement between unions and employers, while a statutory council is established by the state after receiving a request from either unions or employers.

THE COMMISSION FOR CONCILIATION, MEDIATION AND ARBITRATION (THE CCMA)

The CCMA is the best-known and most important institution for the resolution of labour disputes established by the LRA. The CCMA deals with unfair dismissal, unfair labour practice and discrimination disputes. Dismissal disputes, especially for misconduct, constitute the bulk of the CCMA's workload. The CCMA has a director and commissioners who carry out its dispute-resolution functions. It is independent of the state and of any political party or other organisation. Its functions are to attempt to resolve, through conciliation, any dispute referred to it in terms of the LRA and then to arbitrate any dispute that remains unresolved by these means, if the LRA requires arbitration. Most labour disputes are referred to either a bargaining council (if there is a bargaining council registered for the sector and area in which the dispute arises) or the CCMA (if there is no council) for conciliation. This is where a commissioner tries to get the parties to agree to a settlement of the dispute. If conciliation fails, the LRA prescribes that certain disputes return to the council or the CCMA for arbitration. Here, a commissioner or arbitrator hears both parties to the dispute and then makes a final and binding ruling or award.

Other types of dispute are referred to the Labour Court if conciliation fails. These include disputes where an employee automatically claims unfair dismissal in terms of section 187 of the LRA and all discrimination disputes where an employee earns above the threshold. The CCMA does not deal with disputes where an employee alleges discrimination on the grounds of sexual harassment. The CCMA also has other functions. It assists in the establishment of workplace forums and compiles and publishes statistics concerning its activities. The Commission may also:

- advise a party to a dispute about the appropriate dispute-resolution process;
- advise a party to a dispute to obtain legal advice;
- accredit councils or agencies to perform dispute-resolution functions;
- oversee or scrutinise any election or ballot of a registered trade union or registered employers' organisation;
- issue guidelines in relation to any matter dealt with in the Act; and
- publish research.

THE LABOUR COURT AND THE LABOUR APPEAL COURT

The LRA establishes two courts of law to deal specifically with labour disputes. The Labour Court is similar to a provincial division of the High Court. It consists of a Judge President, a Deputy Judge President and as many judges as the President may consider necessary. The Court is constituted before a single judge and may sit in as many courts as the available judges allow. The Court has seats in Johannesburg, Cape Town, Durban and Port Elizabeth. The Court has various functions, which are stipulated in the Act. But unlike the High Court, the Labour Court's jurisdiction is limited. It can only hear and decide disputes as provided by the LRA. For some time now, drawing the line between the jurisdiction of the Labour Court (in other words, the matters the Labour Court can or cannot decide) and other courts has become very difficult.

The Labour Appeal Court can hear and rule on all appeals against final judgments or final orders of the Labour Court. It may rule on any questions arising from proceedings in the Labour Court.

STRIKES AND LOCK-OUTS

The LRA defines a **strike** as 'the partial or complete concerted refusal to work, or the retardation or obstruction of work, by persons who are or have been employed by the same employer or by different employers, for the purpose of remedying a grievance or resolving a dispute in respect of any matter of mutual interest between employer and employee, and every reference to 'work' in this definition includes over-time work, whether it is voluntary or compulsory'. This definition is broad, in that it also covers any refusal to work overtime, irrespective of whether the overtime is compulsory or voluntary.

If a strike or lock-out does not comply with the provisions of the LRA, the Labour Court has exclusive jurisdiction to grant an interdict or order to restrain any person from participating in or furthering such action, and also award damages for any loss attributable to the strike or lock-out.

The LRA also makes provision for protest action and includes stipulations regarding replacement labour during strikes, no work no pay principle, picketing, essential and maintenance services, and lock-outs.

COLLECTIVE AGREEMENTS

The aim of collective bargaining is to reach an agreement. The LRA provides mechanisms through which the parties can achieve this. Although disputes or industrial action may form part of the process of negotiation, the ultimate goal is to conclude collective agreements. The primary forum for collective bargaining is a bargaining council and the LRA contains a number of important provisions relating to bargaining-council agreements. Other collective agreements concluded between a trade union and an employer outside a bargaining council are also provided for.

There are two types of collective agreements: **procedural agreements** and **substantive agreements**. Recognition agreements (procedural) regulate how the parties will conduct the relationship. Substantive agreements deal with the content of the relationship and conditions of service.

AGENCY SHOP AGREEMENTS AND CLOSED SHOP AGREEMENTS

A representative trade union whose members are in a majority in a workplace may conclude with the employer an agency shop agreement requiring the employer to deduct an agreed agency shop fee from the wages of its employees who are not members of the trade union and to whom the agreement applies.

Alternatively, a representative trade union whose members are a majority in a workplace may conclude with the employer a closed shop agreement requiring all employees in respect of whom the agreement applies to be members of the trade union.

WORKPLACE FORUMS

Workplace forums are designed to facilitate a shift at the workplace from an adversarial relationship between trade unions and employers to a joint problem-solving and participatory relationship on certain issues. These forums are also designed to foster co-operative relations through dialogue, information sharing, consultation and joint decision-making, which is not possible through collective-bargaining processes. The focus is on non-wage matters, such as restructuring, the introduction of new technologies, changes in work scheduling, physical conditions of work, health and safety, and those issues that can best be resolved at workplace level.

The **functions** of a workplace forum are to promote the interests of all employees in the workplace, irrespective of whether they are union members, and to enhance efficiency in the workplace.

A workplace forum may be established in the workplace of any employer with more than 100 employees.

Only representative trade unions may apply to the CCMA for the establishment of a workplace forum. Workplace forums employ a consultative approach and a joint decision-making approach.

UNFAIR DISMISSALS

Section 185 of the LRA provides that every employee has the right not to be dismissed unfairly. This protection applies only in respect of employees (and not, for instance, independent contractors). The term 'dismissal' is also defined in the LRA and specific provision is made for a special category of dismissals called **automatically unfair dismissals**. In the case of an automatically unfair dismissal, it is the reason for the dismissal that makes it automatically unfair. If an employee exercises a right conferred by the LRA (such as the right to freedom of association or the right to participate in a protected strike) and he or she is dismissed, the dismissal would automatically be unfair. If the dismissal relates to unfair discrimination (for example, if the employee is dismissed for reasons relating to his or her age, gender, language or political beliefs), the dismissal would be automatically unfair because the employee's right not to be unfairly discriminated against would be at stake. Other forms of automatically unfair dismissals include the following:

- Dismissal when the employee refuses to do the work of another employee who is participating in protected strike action, unless that work is necessary to prevent actual danger to life, personal safety or health;
- Dismissal in order to compel the employee to accept a demand in respect of any matter of mutual interest between the employer and employee;
- Dismissal related to the employee's pregnancy; and
- Dismissal as a result of unfair discrimination, whether directly or indirectly, on any arbitrary ground.

Even if a dismissal is not automatically unfair, it must still comply with certain requirements. A dismissal must be for a valid and fair reason (substantive fairness), and this reason must relate either to the employee's misconduct or incapacity, or to the employer's operational requirements. But a dismissal must also be done in a fair manner. Schedule 8 of the LRA sets out the procedural steps the employer must take in order to ensure that a dismissal is not only substantively fair, but also procedurally fair. The essence of procedural fairness is that an employee must be given an opportunity to be heard. He or she must have the chance to respond to the charges or allegations made by the employer and to say why he or she should not be dismissed.

An employee who feels that he or she has been unfairly dismissed may refer an unfair-dismissal dispute to either a bargaining council or the CCMA for conciliation. If the dismissal is for a reason relating to the employee's misconduct or incapacity, the dispute can then be referred to arbitration if conciliation fails. In the case of most dismissal disputes relating to the employer's operational requirements (including retrenchment), the dispute must be referred to the Labour Court for adjudication if conciliation has failed.

Unfair dismissal

An employee has had ten years' service with an employer, occupying a relatively senior position. The employee has been very active in the activities of the trade union to which he belongs, being a shop steward (a trade-union representative). He has been involved in drawing up strategies for negotiations, and he often represents other employees in disciplinary hearings and grievances. When the employer and the union were in dispute two years previously, the same employee was involved in preparing various documents for the purposes of proceedings in the Labour Court. The employer then dismissed the employee, stating that he had been insubordinate (refusing to comply with lawful and reasonable instructions) and that he had become 'obstructive'. The employee's response was that he had not been dismissed because of alleged misconduct, but because of his trade-union activities. The Court found that the real reason for his dismissal was not the misconduct, as the employer alleged, but the employee's trade-union role and activities. The dismissal was therefore automatically unfair. See *Kroukam v SA Airlink (Pty) Ltd* (2005) 26 ILJ 2153 (LAC).

12.8.5 Communication: Grievances and disciplinary aspects

Communication has a tremendous influence on the quality of labour relations in any organisation. Structures, procedures and policies should be put in place to ensure constructive relations between management and workers. There are various ways of enhancing the quality of communication between the parties in the employment relationship, including one-on-one 'chat sessions', performance appraisals, departmental meetings, health and safety committees, briefing sessions, workplace forums and coaching sessions.

12.8.5.1 The grievance procedure

In the context of labour relations, a **grievance** is an employee's response to a real, perceived or alleged breach of the terms of the employment contract. Possible examples include one-sided changes to the employee's conditions of employment, or an employee being insulted by a supervisor. An effective grievance-handling procedure has many advantages:

- It is a safety valve that will release the tension and dissipate the latent aggression inherent in all businesses.
- It allows the raising and settlement of a grievance by a worker without fear of retribution or victimisation.
- It makes for an open and honest relationship between manager and worker.
- It allows managers to identify and remove legitimate causes of dissatisfaction or conflict.

The LRA is silent on grievance procedures and what a grievance procedure should contain.

12.8.5.2 The disciplinary procedure

Discipline can be described as any action or behaviour on the part of authority (the employer) in a social system that is aimed at stopping member behaviour that threatens to disrupt the functioning of the system. It is therefore a normal and inherent part of any business's actions and responsibilities. Discipline should not be aimed at punishment for the transgression of rules, but rather at rectifying unacceptable behaviour. This is called a **corrective approach** to discipline.

The principles underlying the disciplinary procedure are:

- the employer's right to take disciplinary action against an employee who breaches a rule or standard governing conduct in the workplace (see the box that follows); and
- the employee's right to a fair procedure.

Schedule 8 of the LRA (the Code of Good Practice: Dismissal) contains numerous provisions that are important in the context of workplace discipline. The Code of Good Practice confirms that discipline in the workplace must be corrective. It also provides that discipline must be progressive. **Progressive discipline** means that dismissal is the last resort (except in the case of serious misconduct). Counselling and warnings (ranging from verbal warnings to final written warnings) may be more appropriate. Discipline should be applied consistently by the employer (similar cases should be treated similarly) and disciplinary standards must be communicated to employees. The most common way of communicating disciplinary standards is through the employer's disciplinary code and procedure. This code and procedure is often handed to an employee at the beginning of his or her employment.

Critical thinking

Dismissal for misconduct

Imagine two people – John and his supervisor, Peter. They have had some misunderstandings in the workplace about the way in which a certain piece of work is done. One Friday evening after work, both John and Peter were having a meal at a local restaurant. Words were exchanged and John attacked Peter physically outside the restaurant. Peter was not seriously injured. Would John's actions constitute grounds for dismissal?

12.8.6The Basic Conditions of Employment Act (No. 75 of 1997) (BCEA)

12.8.6.1Introduction and application

The overall purpose of the Basic Conditions of Employment Act (No. 75 of 1997) is to advance economic development and social justice in South Africa. One of the objects of the BCEA is to give effect to and regulate the right to fair labour practices conferred by section 23 of the Constitution of 1996. Other objectives include establishing and enforcing basic conditions of employment and regulating the variation of basic conditions of employment. The BCEA applies to all employers and employees, except members of the National Intelligence Agency, the South African Secret Service, the South African National Academy of Intelligence and the directors and staff of Comsec.

Section 4 of the BCEA sets out the way in which the minimum standards contained in the BCEA interact with employment contracts. A minimum BCEA standard will, for instance, constitute a term of any employment contract unless the existing term in the contract is more favourable to the employee than the one contained in the BCEA. If the contract provides for more days' annual leave than the 21 days' annual leave provided for in the BCEA, the contract will apply. The Basic Conditions of Employment Amendment Bill 2017 aims to amend the act by providing for daily wage payments to certain employees; extending the provisions for monitoring and enforcing by the labour inspector to include enforcement of the National Minimum Wage Act, 2017, the Unemployment Insurance Act and the Unemployment Insurance Contributions Act; as well as providing for claims for underpayment. In 2018, parliament passed a National Minimum Wage Bill that aims to tackle wage inequality. The minimum wage is set at R3500 per month which amounts to R20 per hour. Both the Basic Conditions of Employment Bill 2017 and the Minimum Wage Bill 2018 were signed into law on 23 November 2018. The Minimum Wage Bill came into effect on 1 January 2019. The Act is called the Minimum Wage Act (No. 9 of 2018). Section 4(6) of the Act which provides for

the non-waiver of the payment of the national minimum wage will operate with retrospective effect from 1 May 2017. The Basic Conditions of Employment Act (No.7 of 2018) came into effect immediately after the Minimum Wage Act came into effect on 1 January 2019. (Refer to www.gpwonline.co.za for the latest developments.)

The BCEA[61] covers a wide range of issues. Only a few of these issues will be discussed below.

12.8.6.2 Working time

Chapter 2 of the BCEA, which regulates working hours, does not apply to senior managerial employees, to employees engaged as sales staff who travel to the premises of customers and who regulate their own hours of work, or to employees who work fewer than 24 hours a month for an employer. As a general rule, working hours must be arranged with due regard for the health and safety of employees and with reference to the Code of Good Practice on the Regulation of Working Time.

Ordinary hours of work are limited to a maximum of 45 hours in any week: nine hours if the employee works five days a week or eight hours if the employee works more than five days a week. **Overtime** may only be worked if the employee has agreed to work overtime. No more than ten hours' overtime may be worked in a week. Overtime is expensive: the employer must pay an employee one and a half times the employee's normal wage. As an alternative to overtime pay, the employee may be granted time off.

The BCEA also provides for a **meal interval** (at least 60 minutes long after five hours of continuous work), which may be reduced to 30 minutes by agreement. An employee must have a daily rest period of at least 12 consecutive hours between ending work and commencing work the following day. Every employee must have a rest period of at least 36 consecutive hours each week. The rest period must include a Sunday, unless otherwise agreed. An employee may agree in writing rather to have a longer rest period of 60 consecutive hours every two weeks.

Night work is defined as work performed between 18:00 and 06:00. Employees must be compensated by the payment of an allowance or by a reduction in working hours.

Transport must be available for employees who work at night. Employers must also inform employees who work between 23:00 and 06:00 of the health and safety hazards of night work, and, on request, provide employees with a free medical assessment. The limits on ordinary and overtime working hours, and the requirements for meal intervals and rest periods, do not prevent the performance of emergency work.

The Minister of Labour may exclude or vary the provisions in respect of limits on hours of work and overtime to employees earning more than a certain amount.

12.8.6.3 Leave

Employees are entitled to 21 **consecutive** days' fully paid **annual leave** after every twelve months of continuous employment. An employer may not pay an employee instead of granting annual leave. However, an employee whose employment is terminated must be paid out leave pay due for leave that he or she has not taken. An employee is entitled to six weeks' paid **sick leave** for every 36 months of continuous employment. However, during the first six months of employment, an employee is entitled to only one day's paid sick leave for every 26 days worked. An employer may require a medical certificate for absence of more than two consecutive days from an employee who is regularly away from work before paying the employee for sick leave. Sick leave may not run concurrently with annual leave or notice to terminate services.

A pregnant employee is entitled to four consecutive months' **maternity leave**. This leave may begin up to four weeks before the expected date of birth, unless otherwise agreed or if the employee is required to take the leave earlier for medical reasons. An employer may not require an employee to return to work for six weeks after the birth of a child. An employee may, however, elect to do so if a medical doctor or midwife certifies that she is fit to return to work. Maternity leave is unpaid leave, although an employee is entitled to claim maternity benefits in terms of the Unemployment Insurance Act. It is also possible that the employer may pay maternity leave. Section 25 of the BCEA has been amended to include ten (10) days' parental leave. This means that working fathers are entitled to ten (10) days paternity leave on the day that the child is born, or adoption order granted.

An employee who has worked for at least four months is entitled to three days' paid **family-responsibility leave** per leave cycle. This applies only to employees who work on four or more days in a week. The employee may take this leave in the event of the birth of a child, if the child is sick or if a member of the employee's immediate family dies. An employer may require reasonable proof of the purpose for which this leave is taken before paying the employee. Unused days do not accrue.

12.8.6.4Remuneration, deductions and notice of termination

An employer must pay an employee according to arrangements made between them. An employer may deduct money from an employee's pay only if permitted or required to do so by law, collective agreement, court order or arbitration award. A deduction for loss or damage caused by the employee in the course of employment may be made only by agreement and after the employer has established by a fair procedure that the employee was at fault. An employee may agree in writing to an employer deducting a debt specified in the agreement.

During the first six months of employment, an employment contract may be terminated on one week's notice. The notice period during the remainder of the first year of employment is two weeks, while for employees with more than a year's service, it is four weeks.

The notice period for a farm worker or domestic worker who has worked for more than four weeks is one month. The notice period may be altered (varied) by a collective agreement between the employer and a union. However, even a collective agreement may not reduce a four-week notice period to less than two weeks.

Notice must be given in writing. If the recipient cannot understand the notice, it must be explained to the employee in a language that he or she can understand. An employer may pay the employee the remuneration for the notice period instead of giving notice.

An employee who occupies accommodation situated on the employer's premises or supplied by the employer may elect to remain in the accommodation for the duration of the notice period.

Termination of employment by an employer on notice in terms of the BCEA does not prevent the employee from challenging the **fairness** of the dismissal in terms of the LRA.

On termination of employment, an employee must be paid:

- for any paid time off to which he or she is entitled that he or she has not taken – for example, time off for overtime or Sunday work;
- for any period of annual leave due and not taken; and
- in respect of annual leave entitlement during an incomplete annual leave cycle, either one day's remuneration in respect of every 17 days on which the employee

worked or was entitled to be paid, or remuneration calculated on any other basis, whichever is the most favourable to the employee (this applies only if the employee has been in employment longer than four months).

When an employee's services are terminated because of the operational requirements of the employer (such as retrenchment), **severance pay** has to be paid in addition to other payments due to the employee. The minimum amount of severance pay required by the BCEA is the equivalent of one week's remuneration for each completed year of continuous service. Employees who unreasonably refuse to accept an offer of alternative employment with the same or any other employer forfeit the entitlement to severance pay.

12.8.6.5 Administrative obligations

The employer must:

- issue the employee with written particulars of employment when the employee starts employment (these particulars include the employee's ordinary hours of work, and details of the employee's wage, rate of pay for overtime work and leave);
- retain these particulars of employment for three years after the end of the contract of employment;
- provide an employee with information concerning remuneration, deductions and time worked with regard to his or her pay;
- keep a record of the time worked by each employee, as well as of each employee's remuneration; and
- display, at the workplace, a statement of employees' rights under the Act.

Upon termination of employment, an employee is entitled to a certificate of service.

Simplified provisions apply to employers who have fewer than five employees and to employers of domestic workers.

12.8.6.6 Prohibition of the employment of children and forced labour

No person may employ a child under 15 years of age. The Minister of Labour may make regulations prohibiting or placing conditions on the employment of children over 15 years of age.

12.8.6.7 Variation of basic conditions of employment

Basic conditions of employment may be varied by bargaining council agreements, collective agreements concluded outside a bargaining council and individual agreements concluded by the employer and the employee. The Minister of Labour may also make determinations or issue sectoral determinations.

The Minister of Labour may make sectoral determinations establishing basic conditions of employment for employees in unorganised sectors. A number of important determinations have been made, the best known relating to domestic workers and to farm workers. These sectoral determinations set out minimum wages and other conditions of employment. The BCEA prescribes the procedure that must be followed before a sectoral determination can be made. The Minister must direct a person in the public service to investigate conditions of employment in any sector or area in which it is proposed to make a sectoral determination. On completion of the investigation and after considering any representations made by members of the public, the Director General of the Department of Labour[1] must prepare a report that must be submitted to the Employment Conditions Commission. Only once the Minister has considered the report and the recommendations made by the Commission may a sectoral determination for one or more sectors and areas be made.

12.8.6.8 Employment Conditions Commission and inspectors

The Employment Conditions Commission was established to advise the Minister of Labour on the making of sectoral determinations, the effect of government policies on employment and any matters arising out of the application of the Act.

The Minister of Labour may appoint labour inspectors who perform functions such as promoting, monitoring and enforcing compliance with employment laws. Labour inspectors must advise employees and employers on their rights and obligations in terms of employment laws.

They may also conduct inspections, investigate complaints and secure compliance with an employment law.

12.8.7 The Employment Equity Act (No. 55 of 1998) (EEA)[62]

12.8.7.1 Overview

The main aim of the EEA is to do away with all forms of discrimination in employment in South Africa by promoting equity and non-discrimination in the employment sector. The overall purpose of the Act is to achieve equity in the workplace, chiefly through the following two main elements:

1. The prohibition of unfair discrimination, which applies to all employers
2. Affirmative-action measures, which apply only to ‘designated’ employers.

The most important provisions of the Act are as follows:

- Employers are required to take steps to end unfair discrimination in their employment policies and practices.
- Discrimination against employees or job applicants on the grounds of race, gender, sex, pregnancy, marital status, family responsibility, ethnic or social origin, colour, sexual orientation, age, disability, HIV status, religion, conscience, belief, political opinion, culture, language, birth or on any other arbitrary ground is prohibited.
- Medical and psychometric testing of employees is prohibited unless properly justified.
- Employers must prepare and implement employment equity plans after conducting a human resource planning analysis and consulting with unions and employees.
- Equity plans must contain specific affirmative-action measures to achieve the equitable representation of people from designated groups in all occupational categories and levels in the human resource planning.
- Employers must take measures to reduce disproportionate income differentials progressively.
- Employers must report to the Department of Labour on their implementation of employment equity.
- The EEA has established a Commission of Employment Equity.
- The labour inspectors and the Director-General of the Department of Labour are responsible for enforcing equity obligations.
- Any employer who intends to contract with the state must comply with its employment-equity obligations. Employees are protected from victimisation for exercising rights conferred by the Act.

The Employment Equity Amendment Bill, 2018, was published with the aim of inserting new provisions to allow the Minister of Labour to establish sectoral numerical targets for the purpose of ensuring the equitable representation of suitably qualified people from designated groups (black people, women and persons with a disability) at all occupational levels, and enhance the administration of the Act, including the implementation of section 53 concerning state contracts. At time of writing the 2018 bill has not been signed into law. (Refer to www.gpwonline.co.za for the latest.)

Inherent requirements of a job

A professional couple employed a childminder. The employer (the husband) believed that the childminder should not have children of her own because this would have a negative impact on the attention she would devote to his children. The issue was raised during the initial interview when the childminder indicated that she was single and that she had no immediate plans to have children. Two years later, however, after having established a sound working relationship with the family, the childminder fell pregnant. The employer congratulated her and terminated her employment. One of the employer's arguments was that it was an inherent requirement of her job as childminder that she not have children of her own so that she could devote all her attention to her employer's children. The Labour Court concluded that it was not an inherent requirement of the job of a childminder that she not be pregnant or a parent. See *Wallace v Du Toit* (2006) 27 ILJ 1754 (LC).

12.8.7.2 Scope of application of the EEA

Chapter 2 of the EEA, which deals with unfair discrimination, applies to all employees and employers. Chapter 3 of the EEA, which covers **affirmative action**, applies to 'designated employers' and people from 'designated groups' only.

A designated employer is:

- an employer who employs 50 or more employees;
- an employer who employs fewer than 50 employees, but with a total annual turnover that is equal to or above the applicable annual turnover of a small business in terms of Schedule 4 of the Act;
- a municipality;
- an organ of state, but excluding local spheres of government, the National Defence Force, the National Intelligence Agency and the South African Secret Service; or
- an employer that, in terms of a collective agreement, becomes a designated employer to the extent provided for in the collective agreement.

Designated groups are:

- black people (a general term meaning African people, coloured people and Indian people);
- women; and
- people with disabilities.

12.8.7.3 Prohibition and elimination of unfair discrimination

In Chapter 2 of the EEA, the emphasis is on the prohibition of unfair discrimination. Every employer (not just designated employers) must take steps to promote equal opportunity in the workplace by eliminating unfair discrimination in any employment policy or practice. Section 6 provides that no person may unfairly discriminate (directly or indirectly) against an employee in any employment policy or practice on one or more grounds, including race, gender, sex, pregnancy, marital status, ethnic or social origin, colour, sexual orientation, disability, HIV status, culture or birth. But it is not unfair discrimination to take affirmative-action measures in terms of the EEA or to distinguish, exclude or prefer any person on the basis of an inherent requirement of a job. Sexual harassment constitutes a form of unfair discrimination.

Unfair discrimination

Mr Video has opened up a new store and has placed an advertisement for shop assistants under the age of 25. S applied for the post, even though she was 28 years of age. To justify its policy of employing only people under the age of 25, the employer said that the salary paid to shop assistants was not high, that there was a certain youthful approach and culture in the workplace in which an older person may not feel comfortable, and that older people might be reluctant to take instructions from a younger person. The employer was also

reluctant to appoint S because she was married and had children. The employee's argument was that this constituted unfair discrimination on the basis of her age. In subsequent arbitration proceedings, the CCMA commissioner stated that age should not be taken into consideration when determining whether a group of employees would be compatible. If a person was prepared to work for the salary offered and prepared to accept instructions from a younger person, there was no reason why that person should not perform the work. The CCMA commissioner said the employer had unfairly discriminated against the employee, not only on the basis of her age, but also on the basis of her marital status and family responsibilities. See *Swart v Mr Video (Pty) Ltd* (1998) 19 ILJ 1315 (CCMA).

Medical testing as part of the employment process is also prohibited, unless it is justifiable in the light of medical facts, employment conditions, fair distribution of employee benefits or the inherent requirements of the job. The latest amendments, specifically section 6(4), deal with unfair discrimination by an employer in respect of the terms and conditions of employment of employees doing the same or similar work or work of equal value. A differentiation based on prescribed ground in section 6(1) or any other arbitrary ground will amount to unfair discrimination unless the employer can show that the difference in wages or other conditions of employment are, in fact, based on fair criteria such as experience, skills and responsibility.

12.8.7.4 Affirmative action

The EEA introduces a duty on designated employers to take **affirmative-action measures** and to engage in a process of ensuring that, over time, progress is made towards employment equity. The main focus of the EEA is on getting employers to prepare plans to achieve progress towards employment equity and on the assessment of the plans by the Department of Labour. However, the eventual burden of the EEA on employers will, to a large extent, depend on how the Department of Labour applies the EEA and its approach to the employment equity plans submitted by employers.

In the context of affirmative action, a designated employer has the following obligations in terms of section 13 of the EEA:

- To consult with its employees;
- To conduct an analysis;
- To prepare an employment equity plan; and
- To report to the Director-General on progress made in implementing the employment equity plan.

The enforcement of the affirmative-action provisions is part of a process that starts with a labour inspector and might end up in the Labour Court. The labour inspector may, for instance, issue a compliance order to an employer who refuses to give a written undertaking to comply with the Act, or an employer who fails to comply with such an undertaking.

If an employer fails to comply with the administrative duties in the Act, the Labour Court may impose a hefty fine, ranging from R500 000 for the first offence to R900 000 for four offences. Fines cannot be imposed for not achieving targets, although the Labour Court may make any appropriate order to ensure compliance with the Act if an employer makes no bona fide effort to achieve the targets. However, given South Africa's history, employers should be extremely sensitive as to how they manage employment relationships, particularly because there are so many possible discrimination traps that employers could fall into.

12.8.8 The Skills Development Act (No. 97 of 1998) (SDA)[63]

To improve the low skills base of people in South Africa, the government has promulgated three important pieces of legislation: the Skills Development Act, the Skills Development Levies Act and the National Qualifications Framework Act (NQF). These acts form part of the national skills-development strategy, a new approach that aims, among other things, to link learning to the demands of the world of work, to develop the skills of existing workers, and to enable employers to become more productive and competitive.

It must be noted, however, that there is a clear link between the different pieces of training legislation and the Employment Equity Act. The principles of equity, access and redress underpin the transformation of the legislation. The links between the various pieces of legislation may be explained as follows: the NQF Act makes provision for the National Qualifications Framework (NQF), an integrated framework where all knowledge and skills outcomes can be registered as unit standards. The SDA introduces a strategic approach to skills development by creating Sector Educational and Training Authorities (SETAs), learnerships and skills programmes that are to be assessed against standards and qualifications. The Skills Development Levies Act imposes a skills-development levy on employers, and the Employment Equity Act requires all employers to eliminate unfair discrimination and promote greater representation of black people (that is, African people, coloured people and Indian people), women and people with disabilities.

12.8.8.1 Objectives of the SDA

Section 2 of the SDA sets out the various purposes of the Act, which are:

- to develop the skills of South African human resource planning;
- to increase the levels of investment in education and training in the labour market and to improve the return on investment;
- to use the workplace as an active learning environment, to provide employees with the opportunities to acquire new skills and to provide opportunities for new entrants to the labour market to gain work experience;
- to employ persons who find it difficult to be employed;
- to encourage workers to participate in learning and other training programmes;
- to improve the employment prospects of persons previously disadvantaged by unfair discrimination, and to redress those disadvantages through training and education;
- to ensure the quality of education and training in and for the workplace;
- to help work seekers to find work, retrenched workers to re-enter the labour market and employers to find qualified employees; and
- to provide and regulate employment services.

The following institutions are established by the Act:

- The National Skills Authority
- The National Skills Fund and the skills-development levy grant scheme as stipulated in the Skills Development Levies Act (No. 9 of 1999)
- The SETAs
- Labour centres
- The Quality Council for Trades and Occupations (QCTO)
- Department of Labour provincial offices
- The National Artisan Moderating Body.

12.8.8.2 The National Skills Authority

The main functions of the National Skills Authority are (section 5 of the Act):

•to advise the Minister of Labour on a national skills-development policy and strategy;
•to liaise with SETAs, the national skills-development policy and the national skills-development strategy;
•to report to the Minister on the progress made in the implementation of the national skills-development strategy; and
•to conduct investigations on any matter arising out of the application of the SDA and to liaise with the QCTO.

12.8.8.3 Sector Education and Training Authorities (SETAs)

The establishment of SETAs is described in Chapter 3 of the Act. The Minister of Labour may establish a SETA with a constitution for any national economic sector.

The Minister of Labour must, however, take into account:
•the education and training needs of employers and employees;
•the potential of the proposed sector for coherent occupational structures and career pathing;
•the scope of any national strategies for economic growth and development;
•the organisational structures of the trade unions, employer organisations and government in closely related sectors; and
•any consensus there may be between organised labour, organised employers and relevant government departments as to the definition of any sector, and the financial and organisational ability of the proposed sector to support a SETA.

SETAs have various functions, of which the most important are:
•to develop a sector-skills plan within the framework of the national skills-development strategy;
•to implement its sector-skills plan by establishing learning programmes, approving annual training reports, allocating grants in the prescribed manner to employers, education providers, training providers and workers, and monitoring education and training in the sector;
•to promote learning programmes by identifying workplaces for practical work experience, supporting the development of learning materials, improving the facilitation of learning and assisting in the conclusion of learning programmes;
•to register learning programmes; and
•to liaise with the National Skills Authority on the allocation of grants, skills-development policy or strategy, and a sector-skills plan.

Sector Education and Training Authorities (SETAs)		
1	Agricultural Sector Education Training Authority (AgriSETA)	www.a
2	Banking Sector Education and Training Authority (BankSETA)	www.b
3	Construction Education and Training Authority (CetaSETA)	www.c
4	Chemical Industries Education and Training Authority (ChietaSETA)	www.c
5	Culture Arts, Tourism, Hospitality and Sports SETA	www.c
6	Fibre, Processing and Manufacturing SETA	www.f

7	Energy Sector Education and Training Authority (ESETA)	www.e
8	Education, Training and Development Practices Sector Education and Training Authority (ETDP SETA)	www.e
9	Financial and Accounting Services SETA	www.f
10	Health and Welfare SETA	www.l
11	Media, Advertising, Information and Communication Technologies SETA	www.r
12	Insurance Sector Education and Training Authority (INSETA)	www.i
13	Local Government Sector Education and Training Authority (LGSETA)	www.l
14	Manufacturing, Engineering and Related Services Sector Education and Training Authority (MerSETA)	www.r
15	Mining Qualifications Authority SETA	www.r
16	Public Service Sector Education and Training Authority (PSETA)	www.c
17	Safety and Security Sector Education and Training Authority (SASSETA)	www.s
18	Service Sector Education and Training Authority (ServicesSETA)	www.s
19	Social Security and Development Sector Education and Training Authority (SsdSETA)	www.s
20	Transport Education and Training Authority (TETA)	www.t
21	Wholesale and Retail Sector Education and Training Authority (W&RSETA)	www.v

Source: Economic Development Department. n.d. List of SETAs and contact details. Available at http://www.economic.gov.za/entities-external-links/list-of-setas. [Accessed 21 July 2015].

12.8.8.4Learnerships and apprenticeships

Learnerships are described in Chapter 4 of the Act. A SETA may establish a learnership if it:

- consists of a structured learning component;
- includes practical work experience of a specified nature and duration;
- leads to a qualification registered by the South African Qualifications Authority associated with a trade or occupation; and
- is registered with the Director-General.

Any reference to a learnership in this Act includes an apprenticeship and any reference to a learner includes an apprentice.

Learnership agreements are agreements entered into for a specified period between a learner, an employer or a group of employers, and a training provider. The employer has the responsibility to:

- employ the learner for the period specified in the agreement;
- provide the learner with specified practical work experience; and
- give the learner time to attend the education and training specified in the agreement.

The learner has the responsibility to work for the employer, and to attend the specified education and training. The training provider must provide the education and training specified in the agreement, as well as the learner support specified in the agreement.

The Act also makes provision (in Chapter 6) for the establishment of the Skills Development Planning Unit. Labour centres are to provide employment services for workers, employers and training providers.

12.8.8.5 Financing skills development

The National Skills Fund (Chapter 7 of the SDA) must be credited with:

- 20 per cent of the skills-development levies as stipulated in the Skills Development Levies Act;
- the skills-development levies collected and transferred to the Fund;
- money appropriated by Parliament for the Fund;
- donations to the Fund; and
- money received from any other source.

12.8.8.6 Artisan Development and Quality Council for Trades and Occupations

The Act makes provision for artisan development by establishing a National Artisan Moderating Body. It makes provision for the 'listing of trades' and a 'national register of artisans'. It further requires that no person may obtain an artisan qualification unless he or she has passed a trade test offered by an accredited trade centre.

The Quality Council for Trades and Occupations (QCTO) is established by this Act. The Council consists of 16 members and must, among other things, advise the Minister on all matters related to policy about occupations standards and qualifications. An employer must pay the levy to the Commissioner of Inland Revenue Services.

12.8.9 The Skills Development Levies Act (No. 9 of 1999)[64]

The purpose of the Skills Development Levies Act is to provide for the imposition of a skills-development levy. The most important aspects of the Act are outlined below.

12.8.9.1 Levy to be paid

According to section 3 of the Act, every employer must pay a skills-development levy. The South African Revenue Services is the national collection agency. Every employer must pay a levy at a rate of 1 per cent of an employee's total remuneration. Pensions, superannuation or retiring allowances are, for example, excluded according to section 2(5) of the Act.

Employers who are liable to pay the levy must apply to the Commissioner of the South African Revenue Services to be registered. Employers must indicate the jurisdiction of the SETA within which they belong. They must also register with the relevant SETA.

An employer must pay the levy to the Commissioner of Inland Revenue Services.

12.8.9.2 Payment of levy to Commissioner and refund

An employer must pay the levy to the Commissioner of Inland Revenue Services not later than seven days after the end of each month. The National Skills Fund will receive 20 per cent of the levy. Organisations will be able to claim for financing for up to 80 per cent of the levy, less the set-up and running costs of the SETA.

12.8.9.3 Exemptions from the Act

The following categories of employers are exempted:

- Any public-service employer in the national or provincial government

•Any employer whose remuneration to all of its employees during the following 12-month period will not exceed R500 000 and who is not required to apply for registration in terms of the Fourth Schedule to the Income Tax Act (No. 32 of 1944)
•Any religious or charitable institution that is exempt from income tax
•Any national or provincial public entity that receives 80 per cent or more of its funds from Parliament.

12.8.10The National Qualifications Framework Act (No. 67 of 2008) (NQF)[65]

12.8.10.1Introduction to SAQA

After the publication in 1994 of the National Training Strategy Initiative document, and the debate on it, the government's White Paper on Education and Training was published in 1995. The South African Qualifications Authority Act (No. 58 of 1995) (SAQA) was passed on 4 October 1995. The objective of SAQA is to provide for the development and implementation of the NQF, and to establish the South African Qualifications Authority.

The NQF Bill was published in the Government Gazette No. 31039 of 9 May 2008 and the NQF Act (No. 67 of 2008) was promulgated on 17 March 2009. The NQF Act mainly provides for the NQF, the responsibilities of the Ministers of Education (the Department of Education has been abolished and two new departments have been created: the Department of Higher Education and Training and the Department of Basic Education) and Labour, the South African Qualifications Authority, quality councils and the repeal of the SAQA Act of 1995. The NQF Act is currently being amended. The NQF Amendment Bill was published on 18 November 2016 and seeks to provide for:

•the verification of all qualifications or part–qualifications by the SAQA;
•the formulation of criteria for evaluating foreign qualifications;
•the establishment and maintenance of separate registers of misrepresented or fraudulent qualifications;
•separate register for professional designations;
•the referral of qualifications or part-qualifications to SAQA for verification and evaluation; and
•offences and penalties which have a bearing on fraudulent qualifications.

At time the of writing the 2016 Bill has not been signed into law. (Refer to www.gpwonline.co.za for the latest update).

12.8.10.2The South African National Qualifications Framework (NQF)

The NQF is based on a credit system for achieving learning outcomes. A **learning outcome** is, in essence, an ability developed by the learner that reflects an integration of knowledge and skill that can be transferred to different contexts. Qualifications can be obtained by means of full-time study, part-time study, distance education, work-based learning or a combination of these, together with an assessment of previous learning experiences and general experience.

12.8.10.3Objectives of the NQF

The objectives of the NQF as described in Chapter 2 of the Act are:

•to create an integrated national framework of learning achievements;
•to facilitate access to, and mobility and progression within, education, training and career paths;
•to accelerate the redress of past certain discrimination in education, training and employment opportunities;

- to contribute to the full development of learners; and
- to enhance the quality of education and training.

12.8.10.4 NQF Framework levels

The NQF Act consists of a series of learning achievements arranged in ascending order from levels one to ten (see Table 12.2). Each level is described by a statement of learning achievement, known as a level description. This description provides a broad indication of learning achievements or outcomes for a qualification at that level.

The first sub-framework is the Higher Education level (contemplated in the Higher Education Act). It comprises Levels 5 to 10. The previous Higher Education Band comprised Levels 5 to 8, where Level 7 included higher degrees (honours and professional qualifications) and Level 8 referred to masters and doctoral qualifications.

The second sub-framework is the General and Further Education and Training band (GFET), which concerns formal schooling and Adult Basic Education (contemplated in the GENFETQA or General and Further Education and Training Quality Assurance Act). This sub-framework comprises Levels 1 to 4. Here, a large number of providers can provide education and training. Level 4 is equivalent to Grade 12 of schooling.

The third sub-framework is the Occupational Qualifications Sub Frameworks (OQSF) (contemplated in the Skills Development Act). Note that this band is not reflected on Table 12.2.

The National Qualifications Framework Act (2008) was amended on 3 August 2013 and, among other matters, it was determined that the OQSF should extend from NQF Levels 1 to 8. More information about further developments can be obtained from the Department of Higher Education and Training.

Table 12.2: NQF Framework

NQF Level	Sub-framework	Types of qualifications and certificates
10	Higher Education level	Doctoral degrees
9		Masters degrees
8		Honours/Postgraduate diplomas
7		Bachelors degrees/Advanced diplomas
6		Diplomas/Advanced certificates
5		Higher certificates/Advanced National Certificates
4	General and Further Education Training level	School/College/National Certificate (Grade 12)
3		School/College/Intermediate Certificate
2		School/College/Elementary Certificate
1		General Certificate

Source: Adapted from Department of Higher Education and Training. 2013. Amendment to the determination of sub-framework that comprise the NQF. Notice 891 of 2013. Pretoria: Government Printer. See also www.gpwonline.co.za. [Accessed 21 July 2015].

12.8.10.5 The South African Qualifications Authority

The South African Qualifications Authority continues to exist as a juristic person despite the repeal of the SAQA Act contemplated in Chapter 7. The purposes of the Authority are to:

- oversee the further development and implementation of the NQF; and
- advance the objectives of the NQF contemplated in Chapter 2.

The South African Qualifications Authority is accountable to the Minister. It has various functions, such as overseeing the implementation of the NQF, recommending level descriptors to the Minister of Labour, recognising a professional body and registering its professional designation.

The White Paper for Post-School Education and Training

The White Paper seeks to set out a vision for the type of post-school education and training system the South African government aims to achieve by 2030. It was developed after consideration of the nearly 200 responses to the Green Paper received from various stakeholders in the post-school system. The Green Paper was published in January 2012.

The post-school system is understood as comprising all education and training provision for those who have completed school, those who did not complete their schooling, and those who never attended school. It consists of the following institutions, which fall under the auspices of the Department of Higher Education and Training (DHET):

- 23 public universities;
- 50 public technical and vocational education and training (TVET) colleges (formerly known as further education and training (FET) colleges);
- public adult learning centres (soon to be absorbed into the new community colleges);
- private post-school institutions (registered private FET colleges and private higher education institutions, also to be renamed TVET colleges);
- the SETAs and the National Skills Fund (NSF); and
- regulatory bodies responsible for qualifications and quality assurance in the post-school system – the South African Qualifications Authority (SAQA) and the Quality Councils.

The White Paper sets out strategies to improve the capacity of the post-school education and training system to meet South Africa's needs. It outlines policy directions to guide the DHET and the institutions for which it is responsible in order to contribute to building a developmental state with a vibrant democracy and a flourishing economy. Its main policy objectives are:

- a post-school system that can assist in building a fair and equitable democratic South Africa;
- a single, co-ordinated post-school education and training system;
- expanded access, improved quality and increased diversity of provision;
- a stronger and more co-operative relationship between education and training institutions and the workplace; and
- a post-school education and training system that is responsive to the needs of individual citizens, employers in both public and private sectors, as well as a broader societal and developmental objective.

Source: Department of Higher Education and Training. 2013. *White Paper for Post-school Education and Training: Building an Expanded, Effective and Integrated Post-school System*. Pretoria: Government Printer.

12.8.11 The Occupational Health and Safety Act (No. 85 of 1993) (OHSA)[66]

12.8.11.1 Introduction to OHSA

The main purpose of this Act is to protect employees by ensuring a healthy and safe work environment. The origin of the Act can be found in the late 1800s and early 1900s, when mining operations presented many dangers to workers, and poor working conditions led to various illnesses and, sometimes, to death.

The Act has a wide application and covers all workers, although there are the following exceptions:

- A mining area or any works as defined in the Minerals Act (No. 50 of 1991), except insofar as the Act provides otherwise
- Vessels as defined in the Merchant Shipping Act (No. 57 of 1957).

Note that the Minister may grant exemptions from any or all of the provisions of the Act and that labour brokers are not considered to be employers in terms of this Act.

OHSA provides for an Advisory Council for Occupational Health and Safety, with certain functions as stipulated in the Act.

The Occupational Health and Safety Amendment Bill, 2018, seeks to amend the Occupational Health and Safety Act (No. 85 of 1993). The Bill aims to provide greater protection for workers regarding injuries and diseases in the workplace and to establish a health and safety management system in line with best practice, aimed at safe systems of work. Mandatory risk assessments will be required to eliminate or minimise the risk of exposure to harm in the workplace. At the time of writing the 2018 bill has not been signed into law. (Refer to www.gpwonline.co.za for the latest update).

12.8.11.2 Duties of employers and employees

According to this Act, employers have the following general duties to their employees:

- To provide and maintain a working environment that is safe and without risk to the health of employees.
- To take whichever steps are necessary to eliminate any hazard or potential hazard to the safety or health of employees.
- To provide any information, instructions, training and supervision as may be necessary to ensure the health and safety of all employees.
- To take all necessary steps to ensure that the requirements of this Act are complied with.
- To take any measures that may be necessary in the interests of health and safety.
- To ensure that the work is performed and that this is done under the general supervision of a trained person.
- To keep employees informed at all times.

Employees have the following general duties at work:

- To take reasonable care for their own health and safety, and also that of others.
- To co-operate with their employer regarding this Act and its provisions.
- To carry out lawful orders, and obey health and safety rules and procedures.
- To report any situation that is unsafe or unhealthy.
- To report any accident in which they may have been involved.

12.8.11.3 Representatives and committees

Any employer with more than 20 employees must appoint one or more safety representatives after consultation with the workers. Health and safety representatives may perform certain functions and must perform other functions.

Health and safety representatives may:

- review the effectiveness of health and safety measures;
- identify potential hazards;
- examine causes of incidents in collaboration with the employer;
- investigate complaints by employees;
- make representations to the employer and inspector;
- inspect the workplace;
- participate in consultations with inspectors;
- receive information from inspectors; and
- attend meetings of the health and safety committee.

Health and safety representatives must perform the following functions:

- Visit the site of an accident at all reasonable times and attend any inspection on-site.
- Attend any investigation or formal inquiry in terms of this Act.
- Inspect any document that the employer is required to keep.
- Accompany an inspector on any inspection.
- With the approval of the employer, be accompanied by a technical adviser.
- Participate in any internal health-and-safety audit.

The employer must provide such facilities, assistance and training as the representative may require. A health and safety representative shall not incur any civil liability by reason of the fact that he or she failed to do anything the representative was required to do in terms of this Act.

If two or more health and safety representatives have been designated in a workplace, the employer must establish one or more health and safety committees. The employer must also consult with the committee at each of its meetings to initiate, develop, promote, maintain and review measures to ensure the health and safety of employees at work.

Health and safety committees have the following functions:

- Making recommendations to the employer or inspector
- Discussing any incident that has led to a person's death or illness and reporting the incident to an inspector in writing.

Inspectors are appointed by the Minister and a certificate is issued as proof of their appointment. Their duties include general functions to ensure that the provisions of the Act are complied with – here, they have special powers relating to health and safety and functions with regard to incidents in the workplace.

12.8.12The Compensation for Occupational Injuries and Diseases Act (No. 130 of 1993)[67] (COIDA)

12.8.12.1Introduction to COIDA

In terms of the common law, an employee had no recourse if injured in the course of performing his or her duties. The only way to claim compensation was if intent or negligence on the side of his or her employer could be proved.

The first Act to give some form of protection to the employee was the Workmen's Compensation Act of 1941, which provided for payment of compensation even if intent or negligence on the side of an employer could not be proved. The basic principle has remained the same: compensation will be paid to an employee (or his or her dependants) if an injury has been caused by an accident 'arising out of and in the course of the employee's employment'. It is not necessary for the employee to prove negligence or fault on the part of the employer to qualify for compensation.

The following categories of persons are excluded from the operation of this Act:

- Persons performing military service or undergoing military training who are not Permanent Force members.
- Members of the South African National Defence Force and South African Police Services while acting in defence of the country (note that members of the South African Police Service are covered by this Act while they are performing their normal duties).
- Domestic employees employed as such in a private household.
- Persons who contract for the carrying out of work and themselves engage other persons to perform the work (in other words, contractors).

The Act provides for the establishment of a Compensation Board, whose main function is to advise the Minister of Labour on various matters concerning the application of this Act and its provisions.

The Compensation for Occupational Injuries and Diseases Amendment Bill, 2018, seeks to amend the Compensation for Occupational Injuries and Diseases Amendment Act (No. 130 of 1993) by providing coverage for domestic employees; the rehabilitation, re-integration and return to work of occupationally injured and diseased employees; to regulate the use of healthcare services; to provide for the reopening of claims; to provide for criminal and administrative penalties; to regulate compliance and enforcement and to provide for a no-fault based compensation system. At the time of writing the 2018 bill has not been signed into law. (Refer to www.gpwonline.co.za for the latest update.)

12.8.12.2 Duties of employers

Employers must register and furnish the Commissioner with details about their businesses. They must keep records of all employees, wages paid, and time worked for a period of four years. The record must be sent to the Commissioner each year. The Commissioner will then determine the amount of money that has to be paid by the employer to the Compensation Fund and the employer must comply within 30 days. The state, Parliament, provincial governments, exempted local authorities and employers who have obtained an insurance policy for the extent of their potential liability are exempted from giving the required details and paying the determined sum of money.

12.8.12.3 Procedure to claim compensation

The employee must, as soon as is reasonably possible, notify his or her employer of the accident, as well as his or her intention to instigate a claim. The employer must then notify the Commissioner within seven days. A claim for compensation must be lodged within 12 months of the date of the accident or the date of death.

There are, however, certain requirements that must be met before an employee qualifies for compensation:

- An employer–employee relationship must exist, and the employee must be an employee as defined in this Act.
- Injury or death must have been caused by an accident.
- The accident must have happened in the scope of the employee's employment. This means that the accident happened in the nature of the employee's duties and in the course of his or her service.

12.8.13 The Unemployment Insurance Act (No. 63 of 2001) (UIA)[68]

This Act provides for the payment of benefits for a limited period to people who are ready and willing to work, but are unable to get work for whatever reason.

In terms of the UIA, some employees (those who qualify as contributors in terms of section 3 of the UIA) contribute monthly to the Unemployment Insurance Fund (UIF), which is administered by the Department of Labour. Employers also pay in a certain amount for every contributor (employee) that they employ. An employee who is out of work can claim benefits from the Fund.

The UIA also provides for sickness benefits, benefits to dependants if an employee – referred to as a contributor – dies, and for maternity and adoption benefits.

The UIA should be read in conjunction with the regulations in terms of section 54 of the Act (Government Gazette, No. 23283, 28 March 2002) and the Unemployment Insurance Contributions Act (No. 4 of 2002). The Unemployment Insurance Amendment Act is amended regularly, and the latest amendment was published in 2017. (For the latest update refer to www.gpwonline.co.za.)

12.8.13.1 The scope of the Act

Most employees are covered by the Act. Section 3 of the UIA excludes the following categories of employees:

- Employees employed for fewer than 24 hours a month with a particular employer, and their employers.
- Employees employed in terms of a learnership agreement registered in terms of the Skills Development Act (No. 97 of 1998), and their employers.
- Employees in the national and provincial spheres of government.
- Persons in the Republic on a contract, apprenticeship or learnership, if the employer is required to repatriate the employee, or if the employee is required to leave the Republic at the end of the contract.

The Act provides for the institution of an Unemployment Insurance Board to assist the Minister of Labour.

12.8.13.2 Duties of employers

In terms of the Act, employers have certain duties. Every employer has the following obligations:

- As soon as a business commences activities as an employer, the business must provide the following information about its employees to the Commissioner, irrespective of the earnings of such employees:
  - the street address of the business and of its branches
  - the particulars of the authorised person who is required to carry out the duties of the employer in terms of this Act if the employer is not resident in the Republic, or is a body corporate not registered in the Republic
  - the names, identification numbers and monthly remuneration of each of its employees, and the address at which the employee is employed.
- The business must inform the Commissioner of any change to any information furnished during the previous month before the seventh day of each month.
- The business must pay into the Fund the required amount from the employer and every contributor in his or her employ. (Both the employer and the contributor must pay in an amount equivalent to 1 per cent of the contributor's earnings, thus a total contribution of 2 per cent. The employee's contribution can be deducted from his or her wages. Employers must make monthly payments into the Fund within seven days of the end of the month.)

12.8.13.3 Benefits and allowances

Contributors who lose their jobs are entitled (as are their dependants) to the following benefits:

- **Unemployment benefits**. These are payable for any period of unemployment lasting more than 14 days if the reason for the unemployment is the termination of a contract, dismissal or insolvency. The contributor must be registered as a work seeker with a labour centre established under the Skills Development Act, and must be capable of and available for work.
- **Illness benefits**. These are payable if the contributor is unable to perform work on account of illness and fulfils any prescribed requirements in respect of any specified illness. The period of illness should be 14 days or more.
- **Maternity or adoption benefits**. The contributor will be paid the difference between any maternity or adoption benefit received in terms of any other law or any collective agreement or contract of employment, and the maximum benefit payable in terms of this Act.
- **Dependant's benefits**. These are payable to a surviving spouse, life partner or dependent child if an application is made within six months after the contributor's death.

In all instances, application should be made in accordance with the prescribed requirements.

12.8.14 The Employment Services Act (No. 4 of 2014)[69]

The Employment Services Act was signed by the President on 3 April 2014 and came into operation on 9 August 2015, with the exception of section 13 which deals with the registration of private employment services. The Minister has not yet published the regulations regarding the application and registration procedure of the private employment services. The Act will be promulgated once the Minister has published the regulations in the Government Gazette.

This Act aims to repeal all the employment services provisions contained in the Skills Development Act (No. 97 of 1998) and to provide for a range of measures to promote employment and also to regulate the employment of foreigners.

The following are the overall objectives of the Act:

- To provide for public employment services that will play an active role in employment promotion in order to tackle high levels of unemployment.
- To provide for the establishment of schemes to promote the employment of young work seekers and other vulnerable persons.
- To provide for schemes to assist employees in distressed companies to retain employment.
- To facilitate the employment of foreign nationals in a manner that is consistent with the objectives of this Act and the Immigration Act, 2002.
- To provide for the registration and regulation of private employment agencies.
- To provide for the establishment of the Employment Service Board.
- To provide for the establishment of productivity in South Africa.
- To provide for the establishment of Supported Employment Enterprises.
- To provide for transitional provisions.
- To provide for matters connected therewith.

According to the Act, foreign nationals employed in South Africa will be protected by fair labour practices and may only perform work as authorised in terms of their work permits. Further regulations on employing foreign nationals may be made to encourage

employers to make use of the public employment services before recruiting foreign nationals.

In accordance with the Act, further regulations may also be made that will require employers to notify the Department of Labour of any vacancy or new position that becomes available in their organisations.

12.8.15 The Protection of Personal Information Act (No. 4 of 2013)[70] (POPI)

The Protection of Personal Information Act was signed into law by the President on 19 November 2013 and published in the Government Gazette on 26 November 2013. Once the Act is made effective, companies will be given a year's grace period to comply with it, unless this grace period is extended as allowed by the Act.

The President signed a proclamation that was gazetted on 11 April 2014 in which the effective date of certain sections of the Act was proclaimed as 11 April 2014. The following sections of the Act have been in effect since 11 April 2014:

- Section 1, which deals with the definitions in the Act;
- Part A of Chapter 5, which deals with the establishment of the Information Regulator, the powers, duties and functions of the Regulator, appointment and terms of office of members of the Regulator, and appointment of staff and the chief executive officer;
- Section 112, which deals with the fact that the Minister may make regulations relating to the establishment of the Regulator and that the Regulator may make regulations in terms of certain areas; and
- Section 113, which deals with the procedures for making regulations by the Minister and Regulator.

The Act aims to promote the protection of personal information by private and public bodies and to provide for minimum conditions that should be followed in the lawful processing of information. The Act also provides for the establishment of an Information Regulator. The question has been asked as to when the remaining provisions in the Act will come into force. The remainder of the sections in the Act will come into effect once the information regulator is fully operational. The information regulator has been established in terms of section 39 but is not yet fully operational. The President has appointed the chairperson and members of the information regulator, effective 1 December 2016. It is estimated that the regulator will be fully operational in 2019/2020 whereafter the Act will be promulgated.

12.8.15.1 The purpose of the Act

The main purpose of the Act is to give effect to constitutional right to privacy by safeguarding personal information when processed by a responsible party, subject to justifiable limitations that are aimed at:

- balancing the right to privacy against other rights, particularly the right of access to information; and
- protecting important interest, including the free flow of information within South Africa and across international borders.

The Act seeks to safeguard the integrity of sensitive personal data and, as such, employers must:

- list the data kept (payroll/HR system fields);
- clearly specify why the employer needs the data – i.e. SARS requirement, statistics, Employment Equity Reports, etc.;

- get permission or consent from the employee to store his or her personal information as requested where the data will be stored;
- get permission or consent from the employee to supply information to third parties;
- get permission or consent from external third parties who submit employee information to the employer or payroll vendor; and
- include a clause in their employment contracts in which the employee authorises the employer to use his or her personal information.

In short, for the processing of the data to be legal, the personal information should be processed with the knowledge of the employee, should be linked to a reasonable purpose such as tax or labour law requirements, and should be carefully managed.

12.9 Summary

This chapter provided a brief overview of the activities associated with the human resource function in an organisation. The first part dealt with the recruitment and selection of talent to organisations, the human resource planning and job-analysis process, and the development of employees. The second part dealt with the importance of motivation in the workplace and considered various theories concerning ways to motivate employees. The last part discussed the legal environment that influences human resource managers in an organisation, highlighting the importance of the Constitution as the supreme law of South Africa and giving a brief overview of the most important labour laws that line managers and human resource practitioners should take note of in the workplace.

Small business perspective

Managing people effectively is one of the crucial elements of ensuring organisational success, whether it is a large or small business. In a small business, the owner normally fulfils the role of human resource manager when someone needs to be employed. Although this may be the case, there are certain functions that are generic and need to be performed regardless of the size of the business. These functions include job identification, job description, recruitment and appointment, scheduling work, training and development, remuneration and managing performance, to mention only a few of the basic HR functions.

The scenario changes as the business grows. The human resources functions are normally allocated to another line manager – for example, the accountant. As the business grows even further (a small business could employ up to 50 people), the complexity and the transaction volumes of the human resources function increase. This requires a few dedicated human resource practitioners. Large organisations usually employ a human resource manager and create a human resource department. Employing and retaining the best talent requires professionalism. A small business owner can either decide to retain the human resource function internally or to outsource it. Many outsourced products are available to alleviate the burden on the small business owner and to ensure that legislation is complied with. Small business owners are not exempt from the obligation to adhere to all the labour laws of the country, unless they are specifically excluded. A very important piece of legislation is the Basic Conditions of Employment Act, which prescribes the minimum conditions of employment. To increase productivity, employees need to be given a specific job, the tools to do the job, and the opportunity to grow, be recognised and feel safe in an environment where there is respect, fairness and ethical leadership. High-performing small businesses will be characterised by an engaged and motivated workforce who understand the vision and mission of the business, work in teams and see themselves as partners in the business and not just employees.

KEY TERMS	
affirmative action	learnerships
compensation	legislation
employee development	management by objectives
expectancy theory	motivation
external recruiting	organisational effectiveness
human resource function	performance
human resource planning	performance appraisal
internal recruiting	recruiting
job analysis	rewards
job description	selection
job enrichment	self-efficacy
job specification	strategic partner
labour	

Questions for discussion

Reread the case study at the beginning of the chapter and answer the following questions:

1. What are the most important human resource initiatives on which BASF embarked to maintain and grow its brand?
2. Discuss the role of human resource management in the organisation. Who performs the human resource function?
3. What is the relationship between human resource planning and the recruitment of qualified workers in an organisation? Motivate your answer.
4. Describe human resource development as a sub-function in human resource management and indicate its value in improving organisational success.
5. Performance management and compensation management in organisations are inseparable components. Provide reasons why you agree or disagree with this statement.
6. Briefly discuss motivational strategies. Who is responsible for motivating employees in the organisation?
7. The Labour Relations Act provides that every employee has the right not to be unfairly dismissed. Discuss this statement. (Refer to section 185 of the LRA.)

8.The Constitution is probably the most important piece of legislation in South Africa, as it sets out the structure of the state. Discuss the role of the Constitution in the labour environment.

9.What are the main features of the LRA and the BCEA? Describe them.

10.How is affirmative action part of an employer's responsibility? Explain.

11.Briefly discuss legislation that is applicable to training and development.

12.Which theories address content approaches to motivation? Describe them.

13.Why are the principles of equity theory important for organisational success?

14.What are the differences between the content approach to motivation and the process approach to motivation?

15.Distinguish between job analysis, job description and job specification.

Multiple-choice questions

1.Look at the list of activities below.

i.Training and development opportunities
ii.Recognition for work done
iii.Good client service
iv.Limited communications
v.Limited promotions

Now select the combination of activities that will contribute to improved employee motivation in organisations.

a.i, iii, v
b.i, ii, v
c.ii, iii, iv
d.i, ii, iii

2.Choose one of the options to complete the sentence that follows. According to the __________, minimum standards are set in the workplace that will regulate conditions of service in the absence of more favourable conditions.

a.Labour Relations Act
b.Employment Equity Act
c.Occupational Health and Safety Act
d.Basic Conditions of Employment Act

3.Physiological needs, safety and security needs, esteem needs, and self-actualisation are associated with which one of the following theorists?

a.McClelland
b.Maslow
c.Vroom
d.Herzberg

4.Organisational justice reflects the extent to which employees perceive that they are treated fairly at work. It consists of three components. Which of the following is not one of the three components of organisational justice?

a.Distributive justice

b.Restorative justice
c.Procedural justice
d.Interactional justice

5.The following powers and functions
i.the performance of dispute functions set out in the Act;
ii.the establishment and administration of a fund to be used for resolving disputes; and
iii.the promotion and establishment of training and education schemes; are associated with:
a.the Labour Court
b.a Statutory Council
c.the Bargaining Council
d.the CCMA

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[1]On 29 May 2019 President Cyril Ramaphosa announced that the Department of Labour would be expanded to focus on employment and will be known as the Department of Employment and Labour.

CHAPTER 13

Marketing management

Michael Cant and Ricardo Machado

The purpose of this chapter

It is important to be aware of the role of marketing as a central part of any business's activities. Initially, this chapter considers the evolution of marketing thought, the marketing concept and the definition of marketing. Then, it discusses the components of the marketing process and how these elements are linked. Market research forms part of the whole marketing process. The collection, analysis and interpretation of information is used to understand the behaviour of consumers and to segment the market, as well as to position an organisation's products. The chapter concludes with a discussion of the elements of the marketing mix: the product, price, promotion and distribution as well as the relevance and importance of customer service.

Learning outcomes

On completion of this chapter you should be able to:

- define marketing as a part of the management process
- describe the evolution of marketing thought
- describe the marketing concept
- describe the market offering
- indicate how to use market research to know the environment
- describe the behaviour patterns of consumers
- explain how to segment the consumer market and how objectives are chosen in the market
- define the marketing mix
- describe the product, price, promotion and distribution decisions
- explain what is meant by customer service and customer experience management.

13.1 Introduction

A business organisation can be described as an institution of the free-market system that attempts to satisfy the needs and wants of the community while making a **profit**. A business can also be described as a system that converts inputs (for example, raw material and labour) into outputs **(products** and **services)** for society. The marketing function is that aspect of the business involved in the **marketing process**, which is the transfer of products (or services) to the market.

The marketing process consists of the following:

- Environmental scanning (by means of **market research)** in order to collect information on which marketing management can base sound decisions; and
- The development of a market offering, which consists of tangible products and intangible services, offered at a specific price and convenient place, and about which the consumer has received adequate information.

During this process, marketing management, which is also responsible for the marketing process, needs to monitor competitors, develop strategies to exploit opportunities in the business environment and counter threats, bearing in mind the

organisation’s strengths and weaknesses. The basis of these activities is the primary objective of ensuring the maximisation of profit over the long term.

Marketing is central: it is the bridge between a business and its environment, bringing into contact the business and its market and consumers, providing an important input into the development of the organisation’s mission and strategy, and helping to correlate the resources of the market with the demands of the market. The instruments of the marketing mix are combined with the market offering, which helps consumers to decide whether they want to purchase the product or make use of the service delivered to satisfy their needs and wants. The marketing function is the starting point for the organisation’s management functions, because top management needs to determine what can be achieved in the market before making any decisions about production facilities, employing labour, purchasing raw materials and financing all these activities.

13.2 The evolution of marketing thought

The past decade has seen turbulence in the world economy and many organisations going bankrupt or out of business for various reasons. The economy has not recovered from the world-wide crash in 2008/09, and many companies have reconsidered their focus. Many have gone back to the basics of marketing and looking after the customer. In the early years management believed that contact with consumers was unimportant, but as competition increased and the digital age has evolved so has the pressure from customers. Management need to be more aware of the needs of their customers and focus on their demands more than ever before in order to survive.

Before the Industrial Revolution, households were mainly self-sufficient. Many cottage industries produced goods that were made available for barter or sale. The concept of the intermediary originated when the distances between producers and the market increased. Intermediaries were needed to provide services to facilitate the bartering of products, which were then offered for sale. During the 17th and 18th centuries in South Africa, hawkers visited farms in donkey carts and traded their goods for the farmers’ products.

The technical advances of the Industrial Revolution created machinery capable of mass-manufacturing consumer products in a relatively short time. Large factories were built to house the new machines. These factories necessitated some form of management. Over the years, management approaches to the marketing function changed, with different aspects being emphasised.

The evolution of these management approaches is described below.

13.2.1 Operation-oriented management

Initially, instead of focusing on the needs of the market, management focused on the capabilities of the organisation. Operation-oriented organisations tried to increase the number and variety of products they produced. According to this approach, management asked questions such as: ‘What can we do best?’, ‘What can our engineers design?’ and ‘What is easy to produce, given our equipment?’ In the case of service organisations, management asked: ‘Which services are most convenient for us to offer?’ and ‘Where do our talents lie?’ Organisations that engaged in this approach were organised around product lines. A major disadvantage of operation-oriented management was that management concentrated mainly on encouraging production in order to solve operation problems. The marketing of manufactured products did not cause many problems because consumers were largely unsophisticated and not

accustomed to the consumer products that factories and newly developed modern machinery mass produced.

Moreover, it was hardly necessary to encourage these unsophisticated consumers to buy the new products because they found them extremely desirable. Thus, marketing as a management function was undervalued.

13.2.2 Sales-oriented management

The situation gradually changed and top management succeeded in solving the most pressing operation problems. The new machinery worked steadily, and stocks began to accumulate, which became a problem. During the period 1930–1950, management became more sales oriented in an attempt to sell these mass-produced consumer products. Misleading advertisements and unethical sales methods were employed. The objective was to sell the products at any cost. Management had to get rid of overproduced stock and did not care if consumers were exploited in the process. This led to excessive promotion, and hence high advertising and sales costs. Management was compelled, in the face of increasing competition, to look for more productive marketing methods. This gave rise to the idea that products needed to be marketed instead of merely sold.

13.2.3 Marketing-oriented management

Market-oriented management means that not only the sales message and price of the product need to be considered, but also the quality of the product, the packaging, the choice of distribution channels and the methods of informing potential consumers about the market offering. After 1950, the use of advertising became increasingly important. Management realised that advertising was an effective way of transmitting information to a mass market. Top management focused its attention on the internal organisation of the marketing function. Management also realised that all functional departments of an organisation need to work closely together to ensure the successful marketing of the organisation's products.

13.2.4 Consumer-oriented management

As increasingly competitive consumer products became available and the financial position of consumers improved, consumer demands also started changing. Management began to understand the importance of the consumer demand and the marketing component. It became clear that consumers' needs, demands and preferences needed to be considered when product-related decisions were made. These decisions included choices about the quality and packaging of a product, its brand name, the type of distribution channel used, the price and the marketing communication methods used to inform potential consumers. Management realised that there was no sense in producing a product if there was no demand for it. An organisation that is market driven must also be consumer oriented and must apply a strategic approach to marketing.

13.2.5 The strategic approach to marketing

This is a more recent development in marketing thought. Continual changes in the marketing environment, and the need to ensure the survival and growth of the organisation, meant that management had to concentrate on scanning the environment and on long-term issues. Scanning allowed management to identify environmental changes such as technological innovation, economic influences, political factors, changing consumer preferences, demographic aspects and increasing competition. It

became clear that maintaining close relationships, both internally and externally, was of increasing importance in a changing environment.

This led to relationship marketing.

13.2.6 Relationship marketing

In order to survive in the changing environment, marketing management needed to establish long-term relationships with people and institutions in the environment in which the marketing task was to be performed. A long-term relationship with customers leads to loyalty and the repeated purchase of need-satisfying products. A long-term relationship with a supplier ensures the availability of the raw materials and the inventory. This is especially important in retailing, where out-of-stock situations can inconvenience customers.

The primary objective of relationship marketing is to establish and maintain relationships with loyal, profitable clients. In order to achieve this goal, management needs to focus on the attraction, retention and enhancement of its customer relationships. Loyalty is of particular importance in clients who buy the products or services of the organisation most often. Loyal consumers are not only a basis for an organisation's existing operations, but are also important for the potential growth of the organisation. Marketing management is not responsible for negotiations with suppliers, but in the light of the close relationship between **buyers** and **sellers**, marketing management should help to establish long-term relationships through mutual co-operation. Both buyers and sellers need to strive towards the same objectives. These objectives can be achieved through understanding the needs of the consumer, treating consumers as partners, ensuring that employees satisfy the needs of consumers and providing consumers with the best quality relevant to their needs. The establishment of long-term relationships between producers and intermediaries such as retailers can ensure the availability of products at the right time and in the right place.

The goodwill of society towards the organisation and its products must be fostered in order to establish a favourable corporate image. Here, marketing management can make a considerable contribution because of its close contact with the general public. Internal marketing can be used to involve all personnel (not only those in the marketing department) in marketing objectives and plans. Everyone needs to realise that consumer satisfaction and marketing success will be reflected in their own career opportunities and remuneration. Relationship marketing is used to good effect by market-driven organisations.

This historical review of the evolution of marketing does not refer only to historical developments in marketing thought. Even today, many organisations are still operation or sales oriented. They are not market driven at all, and cannot hope to achieve sustainable success.

The marketing task in a market-driven organisation needs to be performed according to an ethical code or philosophy. This is closely connected to the long-term objective of corporate management. The marketing process itself often provides many opportunities for exploitation, with one participant in a transaction being enriched by taking unfair advantage of another. Many such incidents occur daily. Salespeople often make promises they cannot keep, persuading naïve people to buy their products or to invest money in dubious schemes. Soon afterwards, these salespeople (or organisations) disappear with the money, without delivering the promised product. In such cases, the marketing task is not performed according to an ethical code. In fact,

these examples are not marketing at all, but rather fraud. A swindle has only a short-term objective, is mainly sales oriented, and has no chance of long-term survival.

An ethical code according to which the marketing task ought to be performed is regarded as the basis of all marketing activities and decisions. It is thus necessary to describe it in more detail. The ethical code is known as the marketing concept. It is discussed in the next section.

13.3 The marketing concept

The marketing concept is a well-known concept and can be described as the philosophy by which the marketing task is performed. Four principles are contained in the marketing concept. All four principles are equally important and each one invariably influences the application of the other principles. The marketing concept directs all marketing decisions about products, distribution methods, marketing communication and price determination.

The evolution in marketing thought discussed earlier in this chapter has led to the development of the following four principles of the marketing concept:

1. Profitability
2. Consumer orientation
3. Social responsibility
4. Organisational integration.

As illustrated in the fictitious case study that follows, this company incorporates these four principles in its day-to-day operations.

13.3.1 The principle of profitability

The first principle of the marketing concept in a profit-seeking business is the long-term maximisation of profitability. This is the primary objective of the business in a free-market system. It is therefore also the main objective of marketing management. The principle of profitability is fundamental to the marketing concept. It emphasises profitability instead of sales, which do not necessarily maximise profits.

13.3.2 The principle of consumer orientation

The satisfaction of consumer needs, demands and preferences constitutes a consumer-oriented approach to marketing where emphasis is placed on what the consumer needs. Marketing decision-making is based on what the consumer wants, but even though the consumer is regarded as ‘the king or queen’, complete satisfaction of consumer needs can never be achieved.

Satisfaction can only be given within the constraints of the profit objective and the resources of a business. If the consumer is neglected and his or her wishes are ignored, this can have serious financial implications for the enterprise. Competitors are especially keen to note and turn such opportunities to their own advantage. Consumer orientation also means that the consumer has to be supplied with adequate and correct information about the business’s market offering. This information is usually incorporated into marketing communication messages.

CASE STUDY: Chugani supermarket chain

The Chugani supermarket chain was established in 1976, and has grown from strength to strength over the past 50 years. It has expanded from grocery items to offering clothing and mobile devices. The company has a number of express stores as well as super-saver supermarkets in the main metropolitan areas. At present, the chain consists of 39 super-saver stores, and 82 express stores throughout South Africa. The company’s turnover

increased steadily over the years and is currently close to R1 billion in its 2018 financial year.

Chugani's supermarket chain is actively involved in corporate social responsibility. The company's motto has always been 'Do good to others and you will thrive'. This fact is embedded in their way of doing business, and they do not seek exorbitant profits but rather to make a decent profit over the long term. In order to stay true to this belief, the company is an avid supporter of environmental protection. The company only buys from companies that support the sustainability of the environment and use organic means to produce their wares. No plastic bags are available – not even for sale – and only reusable bags are sold to customers.

Since it started in the 1970s the company has focused on a few key initiatives to establish itself in the market, which include the following:

1. Loyalty card. The company has introduced its own loyalty card, the Chugani Loyalty Card. This card is to say thank you to their customers by providing them with a cash bonus on each purchase. The card has helped Chugani stores to build a better rapport with their customers and to serve them better.
2. Chugani stores has focussed on building relationships with suppliers who are reliable and offer value for money products and who are focussed on preserving the environment. In this way many small businesses are helped as well.
3. By managing its supply chain the company has managed to reduce its distribution costs significantly. The focus is on preventing out-of-stock situations and to increase the number of deliveries, in smaller volumes.
4. Service and efficiency in-store is an ongoing focus of the company. Through its centralised ordering and stock control systems the company is making all processes in-store easier and less complex, resulting in the easier management of their stores and an increased level of service to customers.
5. Recycle drive. The company, as part of its sustainability drive, has embarked on a drive to recycle a range of products including electronics, material and plastic. This has become very successful and a community-driven section has been opened at all super-saver stores to manage these initiatives. The company believes these actions are required by all responsible and caring retailers.

13.3.3 The principle of social responsibility

Besides its responsibility towards the consumers of its products, marketing management also has a responsibility towards the community in which the marketing task is performed. Business often discharges this responsibility by spending money on projects such as housing, education, job creation and health. The objective of these projects is to create a stable economic, social and political environment in which future profits can be optimised. For example, Chugani with its non-use of plastic bags and its waste recycling programme focuses CSR initiatives on environmental sustainability and community involvement. Responsibility in this regard enhances the corporate image in the eyes of employees, consumers and the general public. It has long-term dimensions that might well have a positive influence on the profit position in future. Sporting events and educational institutions such as schools are also often sponsored by large businesses. The other dimension of social responsibility hinges on the authority (legislation) under which the business operates. Should the business act irresponsibly or fail to abide by the laws of the land, reaction in terms of punitive legislation, or even prosecution, could result.

If a business were to disregard the norms of society, consumer resistance could result, thereby harming the primary objective of the business. Nothing should be done to violate the current norms or general moral and ethical standards of the community.

A sponsorship or a social-responsibility project must have a certain marketing benefit for the sponsor. Usually, top management weighs up the merits of potential projects and decides which one to support because of its close relationship with the public and its ability to evaluate projects in terms of marketing benefits. However, it is the responsibility of marketing management to initiate projects.

A sponsorship must be supported by marketing communication to ensure a large audience. A sponsored event must also be well organised and managed. This usually requires the help of the public relations department.

An imaginative and successful social-responsibility project may mean publicity value for the business enterprise. Such projects are usually newsworthy, which ensures coverage in the mass media (newspapers, radio and television). In the case of sporting events, players usually display the name of the sponsor on equipment and clothing, while the sporting event itself offers opportunities to display brand names and marketing messages on billboards, flags and so on.

Marketing management should ensure that nothing is done that could be detrimental to the community. A case in point is the trouble taken to ensure that containers of harmful substances cannot easily be opened by children because of their tamper-proof packaging. Also, an advertisement that mocks religion, for example, offends the prevalent moral or ethical values of the community. This may provoke consumer resistance. Consumers may decide to avoid the product in future.

13.3.4 The principle of organisational integration

This principle expresses the need for close co-operation between all the functions of the business. All the functional decision-making activities should be co-ordinated in a way that will eventually lead to the successful marketing of the products of the business. Organisational integration entails close co-operation between the marketing, operations, purchasing and all other functions of the business in pursuit of the business's mission and objectives. Organisational integration is a prerequisite for success. The primary objective can never be achieved without it. For example, any furniture store needs to ensure that its salespeople do not promise delivery in, say, December while being aware of the fact that the suppliers take their last orders in October. The finance department must also be aware that not all customers will buy using cash and that applications for credit must be processed. It is clear in such a situation that sales, finance and production need to work together and co-ordinate their efforts in order to meet customer needs.

13.3.5 Merits of the marketing concept

The criticism often levelled at marketing – that it purposely exploits consumers, 'robbing' them of hard-earned money to be wasted on useless articles – is refuted by the principles of the marketing concept. The true marketer is proud of his or her product and of the way it satisfies the needs of consumers. The marketer jealously guards the product's name, paying meticulous attention to complaints and criticism, even though his or her main purpose is continually to improve the profit position.

According to the first principle of the marketing concept, long-term maximisation of profitability is the primary objective of the business and also that of marketing management. The business is entitled to this profit to offset the risks involved in developing products for the market. Figure 13.1 illustrates the four principles of the marketing concept, the philosophy according to which all marketing tasks are performed.

This concept provides the background for a full definition of marketing.

Figure 13.1: The marketing concept

CASE STUDY: The Woolworths strategy in implementing the marketing concept

We have six strategic focuses that we drive at a Group level. Our strategies will deliver future-fit businesses that return long-term profit growth and create sustainable value for all our stakeholders.

1. Customer relationships

Strategic objectives for 2019 onwards:

- Our focus is on retaining our current customers, actively acquiring more customers in our target market, and increasing their penetration and spend.
- Our WRewards programme provides our customers with compelling loyalty benefits and offers and is key to building customer loyalty, driving customer acquisition, frequency, and spend.
- We will continue to use our customer database to further leverage data and perform deeper analytics to derive insights to drive further cross-selling and up-selling opportunities, optimise and personalise campaigns.

2. Towards connected retail

Strategic objectives for 2019 onwards:

- We continue to move towards connected retail by delivering exceptional products and experiences to our customers in a seamless and integrated way.
- While stores will remain the dominant channel for South African consumers in the coming years, our customers are becoming increasingly digitally connected, demanding a connected retail experience.
- We are committed to improving our service for online customers and growing and improving our digital presence.
- We will continue to invest in our store footprint.
- We will continue to build the brand in the rest of Africa by focusing on our top countries and stores, growing space in East Africa and Mauritius.

3. Be a leading fashion retailer in the Southern hemisphere

Strategic objectives for 2019 onwards:

- We aim to foster an emotional connection with our customers as we provide them with on-trend, stylish, quality, and affordable products and demonstrate our care for our customers, people, partners, community, and planet.
- Our Woolworths brand is the anchor of our FBH offer.
- Our newly elevated and capacitated design team will drive brand-focused ways of working to provide fashionable, stylish ranges appealing to the brands' relevant customer segment.
- We will ensure that we deliver 'the difference' by focusing on quality in everything that we do, developing desirable product with superior fit, fabric, and finish, enabled by staff and supplier training.
- We will actively focus on strengthening our value perception through delivering best-in-class quality products at surprisingly affordable prices.

4. Become a big food business with a difference

Strategic objectives for 2019 onwards:

•We will reinforce our quality high ground by continuing to drive a 'quality first' mindset to ensure that we provide our customers with quality, safe products.

•Our customers' definition of health has shifted to a philosophy of wellbeing, balancing physical, social, and environmental factors. We are building an integrated world of wellbeing, which takes into account all these factors as we aim to become our customers' food partner in healthy living.

•We will continue to provide innovative, inspiring eating solutions catering for a variety of different customer needs.

•We continue to focus on improving our customers' price and value perceptions. We will continue to use data analytics to inform and tailor our price and promotions decisions to profitably drive sales.

5. Drive synergies and efficiencies across the Group

Strategic objectives for 2019 onwards:

•We are investing in our supply chain to enhance store replenishment and online fulfilment capabilities at lower cost with increased control and elimination of capacity risk, facilitating decreased transport costs and better delivery lead times.

•We are implementing world-class merchandise processes and systems, improving availability of products in both FBH and Food and evolving our IT platform to provide flexibility and support the delivery of innovative, cost-effective, and sustainable solutions.

•We focus on scientific retailing to turn data into actionable insights.

•We recognise that our partnerships with our suppliers provide us with a competitive advantage, and we are committed to growing and protecting these relationships by integrating even more closely with them.

•Our people are critical to the successful execution of our strategy. We aim to attract, inspire, engage, develop, reward, and retain the right and diverse talent, and enable collaboration through a modern and connected people experience.

6. Embed the good business journey throughout our business

Strategic objectives for 2019 onwards:

•We are aligned with the Group's focus areas and sustainability commitments, and will contribute towards these by continuing to develop sustainable practices.

•To achieve our ambition of 'zero packaging waste to landfill', in the medium term, we are focusing on phasing out single-use shopping bags, removing unnecessary single-use plastics from stores, ongoing customer education on the role of packaging in the elimination of food waste, and continuing to partner with government and industry stakeholders to develop technically and commercially viable solutions for recycling different plastics.

•We are passionate about playing our role in building South Africa and supporting inclusive growth. We contribute towards this by developing and communicating clear BBBEE targets for the next three years, and by continuing to support emerging businesses through our Supplier and Enterprise Development programme.

Source: Woolworths Holdings Limited. 2018. *Woolworths Holdings Limited 2018 Integrated Annual Report*. Available at https://www.woolworthsholdings.co.za/wp-content/uploads/2018/09/WHL-2018-Integrated-Report.pdf [Accessed 27 August 2019].

13.4 Defining marketing

Many people, including managers, see marketing as sales or as advertising. However, these are only aspects of marketing. **Marketing** consists of management tasks and decisions directed at successfully meeting opportunities and threats in a dynamic environment, by effectively developing and transferring a need-satisfying market

offering to consumers in such a way that the objectives of the business, the consumer and society will be achieved.[1]

Table 13.1 gives an explanation of the key concepts.

Table 13.1: Key words in the definition of marketing

Management functions	Planning, organising, leading, control
Decisions	Product distribution, marketing communication methods and price
Opportunities	Favourable circumstances in the marketing environment that must be utilised by marketin
Threats	Unfavourable conditions that marketing management must endeavour to change into opp
Dynamic environment	Continually changing environmental variables that necessitate appropriate reaction from r management
Development	Creating a need-satisfying product or service
Transferring	Effectively bridging the gap between the producer and the consumer
Need-satisfying	Properties of a product based on what the consumer wants
Market offering	Product, price, distribution, marketing communication and service
Attainment of objectives: The organisation The consumer Society	 Maximisation of profitability in the long term Need satisfaction within the limits of the resources and capabilities of the enterprise Ensuring the well-being of society in the longer term

13.5The components of the marketing process[2]

In its simplest form, the marketing process entails the transfer of a product or service from one person to another.

Marketing is as old as humankind itself. Even in the earliest societies, people performed marketing activities of one kind or another. One primitive marketing process involved bartering, where, for example, people would barter meat, of which they had a surplus, for grain that another person could spare. Initially, only useful products were bartered. Occasionally, however, one participant in a bartering transaction would use force to compel another person to participate in the exchange process.

In business management, marketing entails the transfer of a product from a business to a consumer. The fundamentals of the marketing process can be described as needs, and a transaction or exchange that leads to the satisfaction of these needs. Every time people attempt to satisfy their needs by means of an exchange, marketing is involved. However, in contrast to primitive bartering, consumers in today's free-market society are free to decide which products or services best satisfy their needs and also how much money they are willing to pay for them.

Consumers cannot be compelled to sacrifice money for a product offered by a marketer. They are free to decide for themselves what they want. However, marketers use marketing strategies to persuade consumers to accept their products. Hence, in its

simplest form, the marketing process involves a transaction between at least two separate parties: a marketer (or organisation) attempting to achieve a specific objective and a consumer who wants to satisfy his or her needs. Figure 13.2 illustrates this process. Work through the discussion that follows while referring to the figure.

In marketing management, four variables (the four Ps) are used for decision-making:

1. The product itself
2. The place where it is offered for sale (distribution of the product)
3. The marketing communication methods used to inform consumers about the product
4. The price, which reflects the product's value to consumers.

Figure 13.2: The marketing process

These four decision-making variables will be discussed in more detail in Section 13.10. The four variables, which are known as the marketing mix, combine to form the market offering that consumers purchase to satisfy their needs.

Since the 1960s, these variables have been known as the four Ps of the marketing mix (product, place, promotion and price). Decisions about the use of the four Ps result in the marketing strategy, which is directed at specific consumers in a specific environment. The market offering to consumers comprises a basic product with need-satisfying attributes. The price of this product, its easy availability and the information in the marketing communication message (advertisements) all contribute to the product's value or utility. A specific market offering is not supposed to satisfy the needs of one individual only, but rather a whole group of consumers or a **market segment.**

The larger the market segment, the more the organisation will benefit. In the total consumer market, there are various different groups of people or market segments. The people in each market segment share common characteristics and preferences. They also have similar consumption patterns and make similar product choices. From all the different market segments, the marketer selects a **target market** or several target markets. The market offering is often modified very slightly to meet the demands of the different target markets. It seldom happens that an organisation has only one target market.

As stated in Chapter 1, it is not possible for people to satisfy all their needs completely because needs are unlimited (even though resources for satisfying them are not). This means that the marketer can never fully meet consumer needs, especially those needs that are unrealistic. An example of an unrealistic need is a consumer demanding a Mercedes Benz for the price of a VW polo. Section 13.7 considers the behaviour patterns of consumers when they are attempting to satisfy unique needs, demands and preferences.

Profit-seeking has already been mentioned. Profit is the reason for the existence of any profit-seeking business. The marketing management of such an organisation therefore needs to strive towards this objective. This can be done by combining the four marketing instruments in an integrated marketing plan to maximise profits. Profitability should not only be achieved in the short term. Profitability in the long term is necessary for the organisation's survival and growth. Organisations that focus on short-term profit maximisation have a tendency to mislead or exploit consumers. To

show any degree of long-term profitable growth, marketing management needs to maintain close contact with the market and to conduct market research regularly. Sometimes consumer preferences in the target market change or new competitors enter the market. Marketing management should be aware of every change that occurs, consider it carefully and then decide what to do about it.

There are often opportunities in the business environment that can be used to an organisation's benefit. There are also threats that have to be countered. By making timely changes in the four marketing instruments, marketing management can respond appropriately to these opportunities and threats. **Market research** (see Section 13.6) is used to gain relevant information about the market, competitors and other environmental changes. Marketing management receives feedback on the market and the environment by conducting market research.

Look again at Figure 13.2 and see the relationship between the various components of the marketing process. Note the direction of the arrows from the environment to marketing management and the target market. Both are influenced by environmental changes. In order to make effective decisions, marketing management needs feedback about the target market and the ever-changing environment.

The marketing process indicates a market-driven approach to marketing management. This approach is a distinctive characteristic of successful modern businesses. All the activities and decisions of marketing management are focused on the demands of the market. This is why market research is important.

13.6 Market research

13.6.1 The need for information

In order to manage a business effectively, a manager needs information. All businesses operate in an environment that is constantly changing. The components of the marketing environment were discussed in Chapter 4, where it was shown that continuous scanning of the micro-environment, market environment and macro-environment is necessary to identify the strong and weak points of the organisation. A SWOT analysis makes it possible to identify these strengths and weaknesses, as well as any opportunities and threats posed to the organisation, before managerial decisions are made.

Information gathered by means of an environmental scan should include information on the following:

- External environmental variables and internal resources in the form of records and reports about current prices;
- Sales figures and market trends;
- Technological changes;
- Changes in market share;
- Consumer preferences;
- New legislation;
- Production schedules; and
- Internal financial problems.

Once it has been gathered, this information is arranged and stored so that it is easily accessible to marketing management.

Note that all marketing decisions are based on information about the micro-environment, market environment and macro-environment. If a problem occurs, existing information sources are consulted.

Sometimes, however, problems about which little or no information is available occur. In such cases, marketing management has to search for information before decisions can be made. This is done by means of market research, which reveals distinctive information that provides solutions for problems regarding marketing decisions. To ensure that managers make good decisions, the information needs to:

- increase understanding of the relevant market segment and its consumers;
- be pertinent to planning and controlling; and
- help in decision-making once alternative sources of information have been considered.

Figure 13.3 indicates that market research includes two broad types of research:

1. Problem-identification research
2. Problem-solving research.

Figure 13.3: The two broad types of research in marketing research

13.6.2 Marketing-research methodology

Marketing research is the function that links people from the public, including the customers of an organisation, to the marketer through information. This information is used to identify and define the opportunities and problems that marketing can tackle. The marketing actions can be refined and evaluated based on the information and it can monitor and improve the marketing process. Marketing research indicates which information is needed to address the problems discovered, and makes use of scientific methods to collect the information, analyse the results and communicate the findings to aid marketing management's decision-making.[3] This definition of market research refers to the use of recognised scientific methods for obtaining market data. One of the most common recognised scientific methods is the **survey method**. There are other research methods that can be used, but only the survey method will be described here. This method is a good example of an ad hoc research project in which the information collected concerns a specific problem in the external or internal environment.

A **questionnaire**, sometimes referred to as a survey instrument or interview schedule, is an instrument that will ask respondents a set of questions and that is then used to generate data necessary for accomplishing research objectives, and is one of the most common survey instruments for the collection of primary data. Questionnaires are extremely useful to a researcher as they standardise the wording and flow of questions and therefore allow for easier analysis of data. Therefore, the instrument can be seen as a control device.[4] Once a finalised questionnaire is in place, it will be distributed with the help of trained **fieldworkers**, either through personal interviews, telephone interviews or self-administered questionnaires. The personal method of questioning is the most expensive and time-consuming method, and fieldworkers need to be highly trained, but the advantages of such a method are that it increases respondent co-operation.[5] Once all data has been collected, the results of the survey can be subjected to statistical analysis to enable the researcher to draw meaningful conclusions. If the research has been conducted in a scientific manner, then the research results may point to a solution of the marketing problem.[6]

There are 12 steps to follow when conducting a survey:[7]

Step 1: Define the research problem. Before a researcher can begin to investigate his or her problem or opportunity, it is imperative that management communicates the nature of the problem or alternative opportunity clearly. This is the most important step a researcher will need to take as without a clearly defined problem, a solution cannot be clearly generated.[8]

Step 2: Identify the research objectives/hypothesis. After having identified a clear research problem, research objectives need to be formulated to state roughly what the research wishes to achieve.[9]

Step 3: Investigate secondary resources. Once all objectives have been stated, the researcher will need to evaluate secondary data to see if any objectives can be achieved. Secondary data is historical data that was compiled for a study other than the one at hand, and is data that can be obtained internally or externally.[10] Examples of secondary data would be that of company records, library sources and government publications. The researcher, after having collected secondary data, will need to evaluate whether the data can satisfy any of the objectives of the study. If it cannot answer any of the research objectives or there are still outstanding research objectives that need to be answered, the researcher will then undertake formal marketing research.

Step 4: Compilation of a questionnaire. The design of a research instrument has a huge influence on whether the marketing problem will be solved. So, it is incredibly important that a researcher pay great attention to its design. The following steps can be utilised as a guideline when designing a questionnaire:[11]

- Specify the information needed.
- Determine the type of questionnaire and method of administration.
- Determine the content of individual questions.
- Decide on the question format and form of response.
- Decide on the phrasing of the individual questions.
- Decide on the sequencing of questions.
- Decide on the physical characteristics and layout of the questionnaire.
- Re-examine steps 1 to 7 and revise if necessary.
- Pre-test the questionnaire and make changes where necessary.

Step 5: Pre-testing of the questionnaire. In order to ensure that all of the questions address the issue under investigation, the questions should be pre-tested in the market before the actual research is conducted. Pretesting will enable a researcher to do the following:[12]

- Determine how long the questionnaire will take the participant to complete.
- Identify problems in completing the questionnaire.
- Determine whether the instructions to the respondent are clear and understandable.
- Determine whether the interviewer was able to follow the format of the questionnaire.
- Determine whether the flow of the questionnaire is conversational and natural.

Step 6: Selecting a sample to distribute the questionnaire to. When the questionnaire has been through the pre-test and all amendments have been made, the researcher will need to select his or her sample. A sample is a subset of a population, and is drawn from the entire population so as to be more cost-effective and to save time,[13] but also to make generalisations about a population. However, in order to generalise research findings, respondents need to have a known chance of selection. For example, if students are to be the respondents, then all students should have an equal chance of being selected. A list of the names and addresses of all the students should be

available to the marketer (researcher), who then randomly draws as many respondents as the size of the sample dictates. Only these students are to be questioned and the fieldworker has to obtain permission to substitute one name for another name that was not included on the original list. If fieldworkers are allowed to pick and choose, they may select only respondents who seem friendly, respondents who are about their own age or respondents whom they know personally. As a rule, it is difficult and expensive to draw a representative sample, although this is the most reliable method. Usually, a sample is drawn according to the judgement of the researcher, who decides how many respondents in each group need to be questioned.

Step 7: Training of the fieldworkers. Once fieldworkers have been selected, they should be trained effectively[14] as fieldwork can become a very challenging task. Training ensures that all fieldworkers know what is expected of them[15] and understand the questionnaire in the same way. According to Wiid and Diggines (2013: 212), it is vital to inform fieldworkers of potential problems that can occur during fieldwork and how they can overcome these challenges. Training should include all aspects of the data collection process as well as what is expected of them from the first moment they make contact with the respondent until the interview is terminated. Typical aspects that need to be discussed at training sessions or in the training manual include the following:

- A general background of the questionnaire, purpose and objectives as well as the sampling method of the particular research study.
- Clear guidelines on how the interview must be prepared.
- How fieldworkers need to react to respondents who do not want to participate in the study.
- How questions should be asked by fieldworkers to gather the correct information.
- The probing methods that can be used to obtain optimal feedback from respondents. It is important to control the execution of the fieldwork and the completed questionnaires.
- The external appearance of the fieldworker.
- The correct method in which fieldworkers have to record the answers and how they should end the interview.

Step 8: Statistical analysis of data collected from questionnaires. A computer is usually used for analysing the data collected from the questionnaires. Statistical methods facilitate the processing of information and the drawing of conclusions. Statistical analysis is used to analyse data by describing the obtained data, measuring the significance or indicating relationships between sets of data.[16] Exploratory data analysis makes it possible for researchers to look at data to determine relationships and trends. Most of the research houses use more specialised programmes (for example, SPSS, SAS or Statistica) for exploratory and inferential statistical analysis. These methods also include determining the mean, percentages, frequencies, confidence intervals, regression and variance analysis.

Step 9: Interpretation of the information. Interpretation means the transformation of the research or statistical results into integrated and meaningful general conclusions and findings.[17] The researcher needs to decide which data to include in the research report and which data is inadequate for the purpose of the study. The conclusion and findings must be relevant to the research objectives and result in a solution to the initial marketing problem or opportunity.[18]

Step 10: Research report and recommendations. The research report 'tells the story' of the research project, gives the method used, and presents the collected information in tables, figures and graphs. In essence, the research report communicates

the knowledge and findings of the research study in an understandable and scientific manner to specific groups of people.[19] It should summarise the statistical results and be presented so that it can be used as direct information for management decisions. Before writing the report, the researcher needs to discuss the important results, conclusions and recommendations with the decision-makers. This will ensure that the final report satisfies the needs of the consumer. The research team's task is complete when the report is complete and has been presented to marketing management.

Step 11: Management evaluation. Management studies the completed research report, evaluates its value and then decides either to accept or reject the recommendations made by the researcher.

Step 12: Implementation of management's decisions. This is the final step, in which management implements the final decisions that were established based on the conclusions from the initial questionnaire and the evaluation of the results. It will hopefully lead to a solution of the problem that was outlined in the first step.

After a period, a further research project will have to be undertaken to determine whether the decisions made and implemented were, indeed, correct.

Example

The research might indicate that 75 per cent of respondents would like your company to add an additional range of products to its existing range, and that they would be prepared to pay a premium for these products. A further 80 per cent of the respondents indicated that they feel they can trust the company to deliver on their promises. From these findings, it is very easy to come to the conclusion that the company should add the product to its range, but it is not so easy to make a recommendation about the extent to which the company can charge a premium for the product. If the questionnaire is compiled properly, the analysis will provide proper answers to questions and recommendations can be made.

The examples we have discussed entailed a survey of consumer demands and preferences. Market research can be done in more or less the same way to investigate problems with dealers, competitors and suppliers. An internal survey can also be conducted to determine the opinions of the personnel of the organisation. Frontline staff, for example, could be chosen as respondents.

13.6.3 Market forecasting

To be able to exploit an opportunity, its potential in terms of profit has to be established. If the potential profit is negligible, then the opportunity may be deemed to be not worth pursuing. Measuring the size of the opportunity entails forecasting future sales (sales forecasting) and forecasting the contribution to profit.

13.6.3.1 Sales forecasting

The following types of forecasting are often used:

- Forecasting done by a panel of experts from within the organisation and from outside;
- Forecasting based on market-research results – for example, the number of potential consumers who have indicated that they want to buy the product could serve as a basis for the sales forecast for the next period;
- Forecasting based on consumers' reactions in test marketing situations;
- Forecasting based on historical data (the previous five years' sales figures could serve as the starting point); and

- Forecasting based on mathematical and statistical models (for example, structural equation modelling).

A combination of sales forecasting methods is often employed in practice. It is, however, extremely difficult to predict future sales as a number of factors can, and will, influence sales. It is nevertheless the task of marketing management to forecast not only future sales, but also to predict how uncontrollable environmental variables will influence the sales figures. In the case of new products, it becomes more difficult to predict sales as there is no history or track record to work from. Even if there is a track record, uncontrollable factors such as the recession of 2009 can seriously affect even the most carefully researched and predicted sales. Accurate sales forecasts can mean the difference between a company's survival and failure.

13.6.3.2 Forecasting of the profit contribution

The forecasting of the profit contribution of a marketing opportunity is normally done for long-term periods.

It is usually done for the full payback period (the time taken to recoup capital expenses incurred in producing a product). During the payback period, the sum of money invested in utilising an opportunity has to be recovered through the earnings generated by sales. The payback amounts include the rate of return decided on at the outset by top management. (The financial aspects of forecasting the profit contribution are discussed in Chapter 14.)

Not all consumers are the same, but all consumers are unpredictable. Thus, it is important to study **consumer behaviour.**

Applying the concept Market research

In today's competitive environment it has become imperative for companies to reduce risk and to conduct market research in many respects. Companies can no longer simply manufacture a product it believes the market wants. Market research is needed to test the opinions and acceptance of the product in the market amongst potential customers before the company invests totally in the product. When Woolworths decided years ago to start offering other grocery or FMCG in their stores and not only their own brand it can be assumed that they would have conducted extensive market research into the viability of adding these brands because the commitment would be very capital intensive.

13.7 Consumer behaviour[20]

Consumer behaviour refers to the behaviour patterns of decision-making units (individuals or families) directly involved in the purchase and use of products, including the decisionmaking processes preceding and determining these behaviour patterns. From this definition, it is clear that consumer behaviour consists of **overt acts** (that is, acts that can be observed by people). A consumer can be seen buying a product, enjoying it, looking at it, placing it back on the shelf or throwing it away unused. At the same time, consumer behaviour also includes **covert processes**, which cannot be seen. A consumer cannot be seen considering his or her financial position, weighing up the merits of different branded products or doubting the promises made in advertising appeals, for example. Marketers need to know why consumers behave as they do, because consumer behaviour can then be **explained, influenced** and **predicted**. Knowledge of the factors that determine consumer behaviour forms the basis for consumer-oriented marketing strategies.

The next section will look at the determinants of consumer behaviour, or the factors that may explain consumer behaviour. The decision-making process and the continual changes in the behaviour patterns of consumers will also be examined.

A consumer receives inputs (stimuli) from his or her environment. The outputs are what happens. The consumer's actions are observable results of the input stimuli. Between the inputs and outputs are the constructs: the processes though which the consumer goes to decide upon his or her actions.

Figure 13.4 illustrates a model that can be used to explain consumer behaviour. **Individual factors** and **group factors** influence consumer decision-making, and may eventually lead to repeat purchasing of a specific market offering.

Figure 13.4: Determinants of consumer behaviour

13.7.1 Determinants of consumer behaviour

Two main groups of factors (determinants) determine consumer behaviour:

1. Individual factors peculiar to a particular person
2. Group factors.

Individual decision-making is usually straightforward. Decision-making by a buying centre requires consideration of the different roles of members of the buying centre, the differing interpretations of objectives, the interpersonal influences, the relative power and the need for some resolution of possible conflicts among members of the buying group.

13.7.1.1 Individual factors

Needs, attitudes, perception, learning abilities and personal traits are individual factors that determine what a consumer will or will not buy. Needs (also called motives) are the driving force behind all behaviour patterns. Maslow's hierarchy of needs was discussed in Chapter 12, where it was shown that people's behaviour patterns are directed at the satisfaction of basic survival, security, social and ego needs.

Consumers buy food, for example, to satisfy a basic **survival** need: hunger. They buy alarm systems to satisfy the need for **security**. They might buy a specific brand of perfume to fulfil the social need for belonging to a certain group of people who appreciate expensive perfume. They might buy expensive cars as a status symbol to provide some measure of ego satisfaction. They might focus on furthering their education to satisfy the need for self-realisation. Maslow maintained that people attempt to satisfy their needs in a specific hierarchical sequence. The basic needs have to be satisfied before other needs can be attended to.

People's needs are unlimited – they never reach a point where all their needs are met. This is why consumers keep buying, even if they already have more possessions than they can use. Advertisements attempt to draw people's attention to unsatisfied needs that can be met by buying a specific product. Although the needs are universal (that is, they apply to all people), need patterns differ from person to person. An asocial person does not have as many social needs as, for example, a very social person. People's needs determine what they decide to buy and what not to buy.

Attitudes also determine purchasing patterns. A consumer with a positive attitude towards a particular product can perhaps be persuaded to buy the product, whereas a person with a negative attitude will not buy the product.

For example, Thabisa – a mother of three, who has a positive attitude towards healthy food – might be persuaded to buy low-GI bread that is known to contain extra vitamins for the benefit of her children. Conversely, a teetotaller (someone who abstains from alcohol) has a negative attitude towards alcoholic beverages, and will therefore not react positively towards advertisements for them. It follows that marketers need to make every effort to prevent the development of negative attitudes towards their market offerings. Once a consumer has decided to avoid a particular product because it was faulty, too expensive, of bad quality or had the wrong taste, the consumer's negative attitude will not change easily. Marketers can, however, try to reinforce existing positive attitudes or turn neutral attitudes into positive attitudes through their marketing communication messages.

Consumers' **perceptions** determine what they pay attention to and what excites their interest. Consumers hear only those things that they want to hear and see only what captures their interest. This means that they subconsciously choose whether to pay attention to a marketing message or not. Furthermore, consumers' perceptions can cause them to attach their own interpretation to a message, which may not be quite what the marketer intended. Consumers seem able to defend or protect themselves against the content of communication in which they are not interested. For this reason, marketers sometimes find it difficult to convey a message in such a way that the person receiving it understands the message. Marketers should bear this in mind when creating marketing messages. Thus, an advertisement needs to be simple to ensure understanding of the message, it should have some impact to attract attention and it must contain a promise of need satisfaction. If an advertisement does not meet these criteria, consumers could distort the message or ignore it completely.

The **learning ability** of consumers determines whether they are able to learn the marketer's 'lesson' about the benefits of a particular product that make it worth paying for. In addition, the marketer should 'teach' consumers the product's name in such a way that they remember it. Sometimes consumers forget the name of the product they intend to purchase, but they are still able to remember the characteristics of the packaging. This underlines the importance of packaging. Reminder advertising, in which only the name of the product is shown in distinctive lettering, helps to remind consumers of what they have learnt from the marketer.

Personality traits also influence consumers' purchasing patterns. People can be described by means of these traits. For example, a person could be described as ambitious, playful or childish. It is difficult to relate personal characteristics to product choice. Usually, people's traits, in conjunction with other characteristics, determine what they buy and use. As a rule, a combination of people's personality traits and other characteristics determine their lifestyle. Different groups have different lifestyles. The lifestyle of those who are high-income earners may be different than those who are average-income earners. Lifestyle classification can be used to segment the consumer market. We shall discuss market segmentation in Section 13.8.

13.7.1.2 Group factors

Group factors refer to the influence of various groups on consumer purchasing patterns. These groups include:

- the family;
- reference groups;
- opinion leaders; and
- cultural groups.

These groups are discussed in more detail below.

THE FAMILY

Children learn their consumer function in their families. At seven, a child already understands that his or her need/s can be satisfied by a process of purchase and consumption. The family is also a decision-making unit whose members decide about purchasing products that will provide the greatest degree of need satisfaction for the family as a whole.

Family members have certain roles. One member may be the buyer (perhaps the father), other members of the family may be the decision-makers (the mother and father), while yet another family member (a son or daughter, for example) may be the consumer. Marketers need to know the role structure of families in their target market, because the marketing message needs to be based on such knowledge. Companies selling breakfast cereal, for example, are known for targeting children by means of their advertising using cartoon characters and toys in these cereal boxes as they know the child could be the decision-maker for this product. Children also play a role in family decision-making by acting as initiators and making suggestions about products of which their parents may know little. For example, teenagers often know more than their parents about how to use a computer or smartphone.

REFERENCE GROUPS

A reference group is any group against which people can evaluate their own behaviour and purchasing patterns. Most people want to be part of some group or other. They may imitate the habits and purchasing patterns of the group in order to gain acceptance. A circle of friends, a social club and a work group are examples of reference groups. Often, people who do not conform to group norms are ignored, held in contempt or ridiculed. For example, a teenage girl wanting to be a part of a skateboarding group would have to have the skateboarding equipment needed and the type of clothing worn by this group in order to 'belong'. A person who wants to become part of a renowned ballet school will have to have the experience and appropriate attire needed to dance with them. Advertisements often portray group approval to attract the attention of those striving to gain acceptance and group membership. For example, an advertisement showing a young couple who have just had an HIV/Aids test with their family and neighbours showing acceptance of the young couple by surrounding them and cheering their actions for taking the test. There are, however, also negative groups with which association is undesirable. Conservative, older and highly educated people, for example, often see young people with many piercings and tattoos as negative groups, and therefore disapprove of their behaviour and purchase decisions. Choosing a particular reference group to portray in an advertisement is difficult, because what one person may regard as a positive group with which to be associated may well be regarded as negative by another person.

There is a strong relationship between reference-group influence and the choice of luxury products, but the relationship is rather weak in the case of necessities. However, if the product is visible, the relationship is stronger. A good example is cosmetic products – as many advertisements suggest, a user of cosmetics products can easily be influenced by the 'expert' advice of other, more experienced users.

OPINION LEADERS

Opinion leaders have an important function in the marketing communication process, acting as a go-between in what is known as the two-step flow of communication. Research has shown that information does not flow directly from the mass media to

individual consumers in the target market, but is channelled through a person, the **opinion leader**. This person interprets and evaluates the information, and then relays acceptance or rejection of the message to other consumers in the market.

The role of the opinion leader is especially important in the purchasing of new products that have a high risk of financial loss. In the case of electronic gadgets, for example, a technology enthusiast will accept the risk of testing a technological gadget before ordinary consumers do. Ordinary consumers will usually become interested after the technology enthusiast has tested and rated the gadget. Celebrities are often technology enthusiasts whom ordinary consumers would wait for to see their rating on the gadgets.

Every consumer is a member of various reference groups. A person could be an opinion leader for a certain product while being a follower for another. One of the tasks of marketing management is to identify the opinion leader and reference group that will ensure the acceptance of its advertising message in a specific target market.

CULTURAL GROUPS

The cultural group to which a person belongs has a strong influence on his or her purchasing and consumption patterns. Culture comprises a complex system of values, norms and symbols, which develop in a society over time and which are shared by the society's members. Cultural values, norms and symbols are created by people and transmitted from generation to generation to ensure survival and facilitate adaptation to circumstances. Schools, churches and other social institutions also play an important role. This process is referred to as socialisation.

Each cultural group comprises several subcultures, each with its own values, norms and symbols. There are four key subcultures, categorised according to nationality, religion, race and geographical area. Besides the four main groups, smaller subcultures can also develop, perhaps according to language, age, interests or occupation.

South African society consists of many cultural groups and subgroups. Although white people are not numerically dominant, their norms, values and symbols exert great influence on the economic environment. For this reason, most advertisements reflect western culture.

13.7.2 Consumer decision-making

Every decision a consumer makes involves risks. The risks are often functional. If a product is deficient or does not work as the consumer expected it to, the consumer feels that he or she has wasted money. There are also social risks involved in decision-making. If the reference group does not approve of the purchase, the consumer may be ridiculed. To reduce the risks inherent in decisionmaking, consumers may wait a long time before making a decision, thereby extending the decision-making process. During this time, and during all the phases of decisionmaking, marketers attempt to influence consumers to decide in favour of their market offering.

There are four influences in any organisational buying decision:

1. The environment
2. The organisation itself
3. The buying group
4. The individual buyer.

Environmental influences include the technological state of the buyer's industry, the state of the economy, government regulations, and legal and cultural factors. These factors influence the organisational climate. Group influences are broken down into

task-related interactions and no-task interactions (personal motives). An individual's motives, perceptions, personality and role within the organisation influence his or her interactions within a buying centre, and thus influence the final decision process.

When making a complex decision about high-priced products, complex products and speciality goods, consumers evaluate brands in a detailed and comprehensive way. More information is sought, and more brands are evaluated than is the case with other types of decision-making situation. Marketing management needs to know how consumer decisions are reached because consumer behaviour almost always entails a choice between alternatives. Marketers want to influence the decisions of the consumer. Consumer decisions are not made suddenly. The decision-making process moves systematically through various phases.

Phase 1: Awareness of an unsatisfied need or a problem. A consumer experiences a difference between the current situation and the situation that he or she desires. This leads to the seeking of a solution to this problem. For example, a torn item of clothing indicates a consumer need. A broken window may indicate a need for a mended window. A broken-down door may make consumers aware of the possibility of a burglary and therefore a need for a security gate or system. Marketers try by means of advertising to make consumers aware of problems and unsatisfied needs.

Phase 2: Gathering information on how best to solve the problem. Consumers recall information or collect relevant information from external sources. They consult friends and family, read advertisements or visit shops to obtain more information. Marketers must make sure that the necessary information is available.

Phase 3: Evaluation of the possible solutions. Consumers use criteria such as price, quality, performance standards, ethical characteristics and aesthetic qualities to gauge the contribution a product will make to need satisfaction and their lifestyle. Conflict is caused by conflicting or unsuitable criteria or criteria that cannot be compared easily. Advertisements therefore need to emphasise the benefits and utility of the product. For example, many security gate advertisements reflect secure gates that are aesthetically appealing and user friendly. These characteristics are important for consumers buying a security gate. The provision of testing the product, a money-back guarantee or a quality mark such as the mark of the South African Bureau of Standards (SABS) can help consumers to resolve conflict.

Phase 4: Decision on a course of action or purchase. Although consumers might indicate intent to buy a product, this does not mean that they will, in fact, do so. Therefore, advertisements encourage the consumer to act and purchase the product – for example, by using an injunction such as: 'Buy now!' When consumers act and buy the product, it entails a sacrifice (money must be paid). The transaction should therefore be concluded as painlessly as possible. If a consumer is forced to queue to pay or comes into contact with uninterested sales staff, he or she may decide to reverse the decision to buy the product. When a consumer has made the decision to buy and is ready to pay, marketers should make a special effort to ensure the consumer's goodwill. Helpful sales staff, credit facilities and point-of-purchase promotions all help to encourage the purchasing action.

Phase 5: Post-purchase evaluation. In this phase, consumers evaluate purchases by using them and testing whether they satisfy their needs. Consumers might wonder whether they have made the right decision. If a product does not provide the satisfaction consumers expect, they may decide not to buy the product again and might influence friends to avoid it. Advertisements are often directed at people who have

already purchased a product in order to reassure them that they have indeed made the right decision.

In the case of an expensive or important product such as a car, decision-making can be a long and arduous process. A person could take months to decide what kind of car to buy. However, in the case of impulse buying, a consumer can move through all five phases of the decision-making process in a few seconds.

Habitual purchasing is the result of previous decisions. If a consumer is loyal to a particular brand, it may become a habit to purchase the product consistently without having to make the decision again every time.

The conclusion that can be drawn is that the theory of consumer behaviour, as it has been described briefly here, is explanatory up to a point. It provides guidelines for influencing consumers – for example, through striking advertisements. However, the many factors that can influence consumer behaviour make it virtually impossible to predict this behaviour. Marketers nevertheless attempt to do so, because market forecasting depends largely on this prediction.

Marketing management will probably never satisfy all the needs, demands and preferences of the market. Therefore, the market strategy should be directed only at those groups (market segments) that are profitable and accessible.

13.8 Market segmentation

A market consists of people with different needs and wants. Not all people like the same colours or the same style of clothing. The range of different watches, shoes, music, types of hotels and so on that are available makes it clear that people have different preferences. It is the responsibility of the marketer to evaluate these needs and wants, and to decide which need/s or wants/s he or she would like to satisfy. No organisation can satisfy all the needs of all consumers (the market). It is therefore important that an organisation focuses on some groups or segments of the market and aims to satisfy just that group's needs.

The term 'market' means different things to different people. In brief, a market consists of a relatively large number of people (or organisations) who:

- have a need for a specific product;
- have the money to buy the product;
- are willing to spend money on it; and
- are legally able to buy the product.

In order for a market to exist, all of these people or organisations need to be in place. So, for example, if you have a ground-breaking product but people do not have money to buy it, you will not have a market for your product. Similarly, a company cannot start marketing a new alcoholic beverage to schoolchildren as it is illegal to do so, even though many children do drink.

Each of the different types of market has its own criteria and characteristics. The total market in a country can be subdivided into the following markets:

- The **consumer market** consists of individuals or households purchasing products for their own consumption.
- The **industrial market** consists of individuals, groups of people or organisations purchasing materials and products to be used in the production process.
- The **resale market** includes individuals, groups or organisations purchasing products in order to sell them to final consumers, for example, retailers.
- The **government market** consists of the state institutions and departments that purchase various products needed to supply services to the public.

In the discussion of the marketing function in this book, attention is focused mainly on the **consumer market**, although the principles of marketing discussed here are also applicable to the other markets. In industrial marketing, though, personal selling is more important than advertising, which is the most effective way of communicating with the consumer market. However, personal selling is seldom used in the government market.

The consumer market is diverse, with numerous markets. Individuals can, for example, be a part of many different markets and play different roles in these different markets. There is a market for vehicles, for food products, for clothing, and so on. There are different submarkets in each of these markets. For example, the automotive market caters for family cars, entry-level cars, sports cars, and public transport motor vehicles, among others. Consumers are members of various markets according to their needs. An elderly couple would not have a need for a family car if their children have left the house and there is no need for a big car. Rather, the elderly couple would most probably want a car that is comfortable, convenient and does not need a lot of maintenance. This is especially true for elderly couples who do not drive around as often as they used to and stay in a retirement complex. Each separate market for a specific product can be subdivided into segments, as not all people have exactly the same needs.

Effective market segmentation should follow these steps:

- Identify the needs of the consumers in the market.
- Group these identified needs of the consumers into homogeneous subgroups or segments that have similar characteristics.
- Select target markets on which the company will focus its marketing effort based on its resources and know-how.
- Position the product or service offering within the selected segment or segments.

13.8.1 The total-market approach (market aggregation)

Marketing management may decide to target all consumers in a similar way if they assume that all potential consumers have similar preferences and needs regarding the market offering. This uniform approach is followed in marketing staples such as bread, milk and sugar, because virtually everyone requires these products and wants them in more or less standard packaging.

Market aggregation is, however, more the exception than the rule. Even in the case of staple items, it is not always applicable. Premier Milling, for example, markets different kinds of Snowflake flour in packs with different colours. Even though it would be more cost effective to have one product, one type of packaging, one price, one distribution channel and one marketing message directed at the mass market, it is seldom possible to do so because the market is not homogeneous. People are not the same, so they have different needs.

It is therefore better for the marketer to try to satisfy the divergent needs of specific market segments rather than to provide only some measure of satisfaction to everyone in the total market.

13.8.2 The market-segmentation approach

Market segmentation is the process in which the total heterogeneous market is divided into smaller, more homogeneous groups with relatively uniform needs or characteristics. Attempts are made to satisfy the needs of different homogeneous groups by developing different market offerings. Marketing management can follow a multi-segment approach, in which many different segments are served with some basic

product or with small product modifications. Alternatively, it can select only one segment of the market and concentrate its marketing effort on that segment.

Figure 13.5 illustrates the three approaches to market segmentation:

1. The total-market approach (market aggregation)
2. A single-segment approach
3. A multi-segment approach.

Figure 13.5: Approaches to market segmentation

The first approach in Figure 13.5 shows that marketing management concentrates on only one market offering aimed at the total market. The second approach shows that marketing management selects a specific target market and aims its market offering only at that market, paying no attention to other segments of the market. The third approach shows that three separate market offerings are made to three different target markets. Remember that any changes, however small, in the product itself (for example, in packaging), the price, the distribution channel, the marketing communication methods or the marketing communication messages mean that a different market offering is being made.

Adidas marketing offers deck shoes identifying fashion-conscious men and elderly men as separate market segments in addition to the sailors who make use of the shoes. Even though the shoes are sold with the same packaging, and at the same price, the marketing messages differ. In reality, this means that three different market offerings are being made to three separate market segments. If the product is intended for sailors, the advertisement shows a man on a yacht. When it is intended for fashion-conscious men, it will be advertised with style in mind; when advertised to elderly men, it will portrait the safety elements of a non-slip shoe. Even when marketing management has succeeded in identifying a promising segment of the market, it does not necessarily follow that a market offering will be developed for that segment. Certain requirements have to be satisfied before marketing management can claim a segment as a target market.

13.8.3 Requirements for meaningful market segmentation

For segmentation to be meaningful, the following criteria must be met:

- **The segment must be identifiable and measurable**. In other words, it must be possible to identify the segment and measure its size. Data about provinces, sex, age and so on are readily available, but data on people who are prepared to test a new medical product are not readily available.
- **The segment must be substantial and sustainable**. In other words, the segment should be large enough to make profitable exploitation possible and it must be sustainable over a period of time. The fragmented population in South Africa makes it possible to distinguish various small market segments. Some of these segments are, however, so small that it would not be profitable to develop separate market offerings for them all.
- **The segment must be reachable**. In other words, it should be possible for marketing management to reach its chosen segment with its product and marketing communication methods.

- **The segment must be responsive**. For a segment to be cultivated, it needs to be receptive to a separate approach. If all consumers are equally conscious of a product, there is no need to offer high, medium and low prices to different segments.

When marketing management is satisfied that these requirements have been met with regard to a particular market segment, it can select this segment as a target market. A target market is a specific segment for which marketing management can develop and implement a marketing strategy. The question to be answered now is: How does marketing management isolate the factors or criteria according to which homogeneous groups in the total consumer market are to be distinguished? Several of these criteria have already been mentioned – for example, age and language.

13.8.4 Criteria for market segmentation

The total market can be **segmented** into different groups according to a variety of criteria, as shown in Table 13.2.

Table 13.2: Criteria (bases) for segmenting consumer markets

Bases	Possible variables
Geographic	
Region	KwaZulu-Natal, Gauteng, Northern Province, Western Province
Size of city or town	Under 5 000, 5 001–10 000, 10 0001–20 000, over 20 001 inhabitants
Density	Rural, suburban, urban
Climate	Very hot and dry, hot and humid, summer rainfall, winter rainfall
Demographic	
Age	Under 10, 10–15, 16–20, 21–25, 26–30, above 30
Gender	Male, female
Family size	One and two, three and four, more than four family members
Family life cycle	Young, married without children; young, married with children; older, married with children; married children living at home; single individuals
Income	Under R10 000, R10 001–R30 000, R30 001–R50 000, R50 001–R70 000, R70 001–R90 000, ove
Occupation	Professional and technical, managerial, clerical, sales and related services, farmers, students, hous unemployed, retired
Religion	Catholic, Protestant, Hindu, Muslim, Jewish
Race	Black, white, coloured, Asian
Education	Grade 10, matric, diploma, degree, postgraduate

Psychographic	
Lifestyle	Liberal, conservative
Personality	Outgoing, authoritarian, impulsive, motivated
Social class	Lower-class, middle-class, upper-class
Behavioural	
Purchase occasion	Regular use, special occasion
Benefits sought	Economy, convenience, prestige, speed, service
User status	Non-user, ex-user, potential user, regular user
Usage rate	Light user, medium user, heavy user
Loyalty status	Absolute, strong, medium, none
Readiness stage	Intending to buy, desirous, interested, informed, aware, unaware
Attitude to product	Hostile, negative, indifferent, positive, enthusiastic

Source: Adapted from Cant, M.C., Van Heerden, C.H. & Makhitha, M.M. (Eds). 2017. *Marketing management: A South African perspective*. Cape Town: Juta, pp. 85-86. Reprinted by permission of Juta and Company (Pty) Ltd.

Segmenting the market according to demographic and geographic criteria usually gives a good indication of the potential of particular market segments – that is, the number of consumers in each segment. Segmentation according to the psychographic and product-usage criteria gives an indication of the reasons for consumers' choice and purchase of specific products. Each of these criteria merits further scrutiny.

13.8.4.1 Geographic criteria

Geographic criteria relate to place of residence. Geographic factors result in the development of different need patterns, thereby affording marketers opportunities they can use.

13.8.4.2 Demographic criteria

Marketers often segment the market according to **demographic** criteria, as the information is easily obtainable. For example, it is easy to determine how many students are registered for this course, and therefore how large the potential market is for this book.

The other demographic variables mentioned in Table 13.2 are self-explanatory and therefore will not be discussed separately.

13.8.4.3 Psychographic criteria

Table 13.2 shows the main **psychographic** variables according to which markets can be segmented. The main variables in this group are personality factors and lifestyle.

Personality traits are difficult to quantify, but they nevertheless offer opportunities to marketing management for market segmentation.

Aggressiveness, conservatism, optimism, progressiveness and materialism are examples of personality traits of individuals. Marketers know that these traits are related to product and brand selection. Many advertisements aimed at men, for example, contain elements of aggressiveness to capture their attention because men tend to be more aggressive than women. Lifestyle segmentation comprises a group of characteristics known as the AIO classification (activities, interests and opinions of the consumers).

13.8.4.4 Behavioural criteria

Table 13.2 shows the behavioural criteria according to which the consumer market can be segmented. Product usage refers to the way in which products are used by different consumers.

Consumers can be light, medium or heavy users of a product, and they can be existing or potential consumers. Teetotallers are non-users of liquor, and all attempts by a marketer to persuade this group to become users will be to no avail. However, marketers often attempt to persuade light and medium consumers of a specific product to purchase more of the product. A good example is potato chips, which were initially seen as a snack for consumption at social events. However, consumers are now encouraged to eat them at any time of the day, even during ordinary meals. **Brand loyalty** is a behavioural criterion that is encouraged by marketers because when consumers are loyal to a particular brand, the competitive position of the marketer is strengthened. Brand-loyal consumers buy products that have provided need satisfaction previously, and they do not think twice about doing so. Black consumers tend to be more brand loyal than white consumers. The following brands enjoy considerable loyalty from many black consumers: Super Sun, Zambuk and Black Label. Brand loyalty develops only if a product provides such complete need satisfaction that the consumer never even considers competing products.

Some consumers are extremely **price sensitive** and can be persuaded to buy a product by means of small decreases in price. These consumers are always on the lookout for discount shops and like to bargain. Most wealthy consumers are not price sensitive. They will usually purchase what they need and are averse to shopping around for bargains or sales.

Reverse price sensitivity means that consumers react negatively when a price is perceived to be too low. They immediately conclude that the cheap product lacks quality. They associate high prices with good quality and low prices with poor quality. If prices are reduced, these consumers buy less instead of more.

Consumers can also be sensitive to service, quality and advertisements. The advertisement promising: 'You are Number One' is directed at consumers who are sensitive to service quality, while the 'Quest for Zero Defect' points to quality excellence for quality-sensitive buyers. Other consumers are sensitive to advertising and respond immediately when an advertisement attracts their attention. They are ready to buy if they perceive the message as promising.

The total potential market for a product can also be divided into segments according to the benefits a product is thought to offer. The box that follows shows the segmentation of the toothpaste market according to benefits.

Product benefits of toothpaste

The product benefits that a consumer might expect from toothpaste may include:

- fresh breath;

•cavity protection;
•white teeth;
•social acceptance; and
•effectiveness.

The market for interactive gaming is also segmented according to **product benefits**. Some people use interactive gaming like Wii as a family gaming experience or as a toy for children. Some people use interactive gaming to keep their children occupied, and others use it to pass the time, while there are those that use products like the Wii Fit, an exercise programme that allows for the gamer to participate in fitness programmes. Some marketers follow a multi-segment approach and promise all the benefits listed above. According to its advertisement, the Wii may be used for family time, occupying children and exercise, but also saves money by having all of this in the comfort of your home. Criteria are often combined to define a **segment profile.**

13.8.5Segment profiles

Demographic, geographic and usage criteria together provide a profile of a specific segment. For example, Edgars can segment its consumers into four different groupings: babies, young children, young adults and mature adults. The groupings are made to cater for that segment's needs and for its particular age groupings.

13.9Target-market selection and positioning

Once the heterogeneous total mass market has been subdivided into smaller homogeneous segments, the marketer has to identify a segment that looks promising as a target market. The objectives and resources of the business have to be carefully considered before a target market can be selected. When selecting target markets, the abilities and expertise of the business have to be linked to the characteristics of consumers in the different market segments. A market offering is developed for each target market chosen in this manner. It is clear that target-market selection does not necessarily involve only one target market. Numerous individual target markets can be selected.

The fact that marketing management has analysed the market and decided to target a specific market does not mean that the organisation now owns that target market. On the contrary, a survey of the market would probably have indicated the presence of competitors. Marketing management has to consider the competitive situation in the market carefully and decide if it wishes to confront competitors directly or if it should rather seek and occupy a gap (or niche) in the market. A positioning guide is often used to show the competitive position confronting marketing management. This guide makes it easier to identify gaps in the market. Figure 13.6 is an example of such a guide.

Figure 13.6: Positioning guide

Source: Du Toit, G.S., Erasmus, B.J. & Strydom, J.W. 2010. *Introduction to business management*. Eighth edition. Cape Town: Oxford University Press.

Once marketing management has segmented the market and selected a target market or markets, a decision must be made regarding the four marketing instruments

that will be aimed at the market/s. These four marketing instruments are discussed in Section 13.10.

13.10 The marketing instruments

Marketing management constantly modifies decisions about the four marketing-mix instruments (that is, the product, distribution, marketing communications and pricing) as circumstances change and consumers' acceptance of the product gradually increases. For instance, consumers first have to be educated to accept an innovation – that is, an original new product. At the same time, an existing product that is in a later phase of its life cycle should be actively promoted to prevent consumers from possibly buying a competing product.

13.11 Product decisions

13.11.1 The product offering

The **product offering** of a business may comprise a single product item or a number of **product items** and **product ranges**. This product offering changes according to the demands of time and the situation of the market.

Product decisions entail decision-making about the product itself (for example, the type of packaging and the brand), as well as about the composition of the product offering. Before these decisions can be discussed, the concept 'product' will be described in greater detail.

The differences between the concepts 'product offering', 'product range' and 'product item'

A product offering consists of various product ranges. The product ranges of Mercedes-Benz consist of the following:

- Passenger cars
- Delivery vehicles
- SUVs (sport utility vehicles)
- Heavy transport vehicles (also called trucks).

The product range consists of various product lines. The passenger-car product range consists of four product lines:

A-class
B-class
C-class
E-class,

In the C-class product line, there are a number of product items, of which the C200 is an example.

13.11.2 What is a product?

A **product** may be described as a composition of tangible and intangible need-satisfying utilities offered to consumers by a business, so that the consumers can take note of them, procure them and use them. The need-satisfying utilities may include consumer products, services (for example, services provided by a hairdresser), personalities (such as a sports star), places (such as the local shopping mall), institutions (such as the SPCA) and ideas (such as the innovation hub). As indicated in a previous section of this chapter, this book focuses on consumer products. Product decisions, however, also apply to the other types of 'products' or utilities mentioned above.

A consumer product consists of:

- a **core product** that can be described in terms of technical and physical qualities (for example, a watch that has an automatic chronograph movement feature);
- a **formal product**, which, in addition to the core product, may also include specific features such as style, quality, brand and packaging (for example, a watch that has the Breitling trademark on it packed in the specific packaging for Breitling);
- a **need-satisfying product** comprising further need-satisfying utilities, such as guarantees, installation, repair services and free delivery (for example, the watch is guaranteed to have been manufactured by the best artisans);
- the **product image** that gives the product symbolic value by means of the type of marketing message, price and choice of distribution outlet (Breitling watches, for example, are only sold at specific shops and their price is higher than normal watches); and
- the **total product** comprising all the above-mentioned components (that is, a Breitling watch, made by one of the best watch companies and which are only sold in selected retail outlets).

When the concept of the total product is considered, it immediately becomes clear that there are large differences between different consumer products. Consumer products differ in respect of their particular features, their manufacturing and marketing methods, and their purposes. Marketing management consequently has to classify products in more or less homogeneous categories, according to their different qualities.

13.11.3 Classification of consumer products

Consumer products are intended for immediate use by households or consumers. A distinction can be drawn between durable and non-durable consumer products. **Durable consumer products**, such as a coffee maker, scooters and computers, are utilised over a longer period, whereas **non-durable consumer products**, such as vegetables, fish and milk, have a relatively short lifespan. Consumer products can also be classified, on the basis of consumer buying habits, into convenience products, shopping products and speciality products.

- **Convenience products** are products such as magazines, snacks, cough syrup, eggs and margarine, which should be within easy reach of the consumer. The qualities and prices of competing convenience products are reasonably homogeneous, and the products do not require much explanation to be sold. Furthermore, the retailer does not receive much incentive to 'push' one brand in favour of another.
- **Shopping products** are products (for example, clothing and jewellery) for which the consumer wants to compare suitability, quality, price and style before buying. He or she does not have sufficient knowledge of the range of shopping products available and will 'shop around' to acquire information. The consumer rarely has enough information and knowledge to visit just one store to buy the product. He or she shops around to obtain enough information about the trademark before buying the product. New Balance shoes are examples of shopping products.
- **Speciality products** are products with unique characteristics for which consumers will make a special purchasing effort. A purchaser will often insist on a specific brand. Examples are cars (such as a Mercedes-Benz SLK AMG sports car), television sets (such as Samsung) and music systems (such as Bang & Olufsen).

It is important to note that the classification outlined above is based on the purchasing habits of consumers. As consumer purchasing habits differ, the same product (for example, chocolates) may be a convenience product for one consumer, a shopping product for another consumer and a speciality product for yet another consumer.

The marketer has to make various product decisions based on the nature of the product to be marketed. One of the most important product decisions has to do with the branding and brands. Almost all the consumer products classified into homogeneous groups have brands distinguishing them from competing products.

CASE STUDY: Retail management strategies

The past years have seen many retailers closing down stores in an effort to stay profitable and to survive. A number of large US chains that were once household names have closed down hundreds of stores in 2018 alone. As these retailers have struggled, a select number of major chains has found ways to increase earnings and sales. Furthermore, food retailers, while representing only 19 per cent of retail sales over the past decade, have captured 28 per cent of industry profits.

What – if anything – are these companies doing differently from their competitors?

Research indicates that in order to excel in today's highly saturated retail markets, companies need to abandon the geographic expansionism that, ironically, created their original success. Instead, they need to initiate new management strategies based on profit-driven product selection and customer targeting. At the heart of the shift is the introduction of financial discipline into the marketing process. Retailers need to be ruthless about pulling unprofitable products from the shelves and avoiding high-volume but low-profit customer segments.

Three Retail Management Strategies

To maximise profits, retail companies need to excel in three areas. First, they need to approach the early years of their growth in the same way that Napoleon approached empire building: the more territory, the better.

Second, once they saturate their markets with outlets, companies can sustain their earnings growth by improving the mix of products they sell.

Finally, as gains from improved product mix level off, retailers need to alter their promotion, advertising and merchandising strategies to better respond to local market preferences.

Most retailers have learned the skills associated with the first phase – real estate acquisitions and store openings. Few have the requisite management capabilities for the second two: improving product and customer profitability

Phase 1	Phase 2	Phase 3
Pursuing geographic expansion	**Improving product selection**	**Increasing customer value**
•Acquiring real estate •Developing the supply chain •Recruiting and training store personnel •Building the brand	•Understanding category profitability •Eliminating unprofitable products •Managing the product offering	•Understanding custome •Targeting desired custo •Managing customer val

Improving product selection

During their rapid geographic expansion, retailers typically bring together a vast array of products to attract customers. This may make economic sense at first, as retailers are trying to generate excitement and offer convenience. But, over time, rapid growth can conceal the fact that many of these products do not make money for the company.

The next step is to become more selective in which products to offer and which to discontinue. There are three things in particular to focus on:

1.Understanding Category Profitability. It is important for retailers to have an accurate understanding of which products are contributing to the value of the company.

Typically, product profitability is measured superficially – in terms of gross margin or operating contribution, for example. But each product's profitability is also affected by shared costs, such as store operations, head office marketing and administrative expenses. It is also affected by capital costs, such as the holding cost of inventory or the capital cost of physical facilities that are related to the product category. Unfortunately, most companies have not developed the ability to track these costs on a product-specific basis and thus lack a clear picture of which products are economically profitable.

2.Eliminating Unprofitable Products. A more accurate understanding of product economics can help retailers put their existing square footage to more profitable use. This requires 'housecleaning' to prune those categories that are creating a drag on the bottom line, which in turn may require major changes in corporate and business unit strategy. For example, one reason that stores end up with so many unprofitable products is that corporate headquarters has a policy of shipping each product to all stores – and in the same quantity. Corporate headquarters should rather offer a menu of products that local stores can choose from in the quantities they need. This can result in a higher percentage of the store space being used to sell high-margin and/or quick turn products.

3.Managing the Product Offering. One of the more impressive examples of marketing high-margin products is the UK health and beauty retailer Boots, which over the last decade has become an industry leader in knowing where it makes money in its product portfolio and how to exploit that understanding through merchandising, store layout and other marketing techniques. For example, the company recognised that its 'own-brand' toiletry and cosmetics products were doing extremely well. Management realised that the chain's ubiquity in the UK (more than 1 400 stores) presented an opportunity to increase the percentage of own-brand products in its product mix. Executives grew the business smartly, picking a few categories, like cosmetics, where they had a pre-existing brand position on which to build.

Source: Werner, U., McDermott, J. & Rotz, G. 2004. Retailers at the crossroads: how to develop profitable new growth strategies. *Journal of Business Strategy*, 25(2): 10-17. Available at https://doi.org/10.1108/02756660410525353. ISSN: 0275-6668.

13.11.4 Brand decisions

13.11.4.1 The meaning of brands

A brand is a mark that is unique to the product items or ranges produced and marketed by a particular business, and that is chosen to distinguish them from similar competing products. The brand of a product includes the brand name and a specially designed trademark. The **brand name** is a word, a letter or a group of words (for example, Adidas). Consumers use this name when they intend to buy the product. The concept of a brand name is therefore much narrower than the concept of a brand (in this case, the three stripes typifies the Adidas trademark).

Brands can be registered under the Trademarks Act (No. 194 of 1993) (as amended). Such registration protects a business's exclusive right to use a particular brand for a period of ten years.

Figure 13.7 shows two well-known South African brands. Some brands consist of only a brand name written in distinctive lettering. Coca-Cola is a good example. Some trademarks are so familiar that the names are almost unnecessary. The distinctive names and trademarks are often used in reminder advertising – for example, on the large billboards (usually positioned right in front of the television cameras) surrounding the field in a rugby stadium.

Figure 13.7 shows the names of products in their characteristic lettering as well as their trademarks. In each case, the reader knows what kind of product it is and, in most cases, what the marketing message is, although these are not mentioned.

Figure 13.7: Well-known South African brands

Source: Pick n Pay. Reprinted by permission of John Bradshaw. Head of Marketing, Pick n Pay Retailers (Pty) Ltd. Telkom. Reprinted by permission of © Telkom SA SOC Limited.

13.11.4.2Advantages offered by the use of brands

Well-known brands offer the following advantages to **consumers:**

- They facilitate the identification of products when purchasing.
- They assure consumers of a quality standard they can count on.
- They offer a certain degree of protection to consumers because branded products can be identified with a specific producer.
- They facilitate decision-making because consumers easily recognise the brands they usually buy.
- They serve as a warning against products that do not meet requirements set by consumers.

The use of brands has the following advantages for the **marketer:**

- Brands are the foundation stone of the marketing communication strategy, where the message indicates precisely which product should be purchased.
- Brands promote brand loyalty among consumers and make product substitution by the retailer or consumer more difficult. For example, a consumer might insist on buying a Samsung fridge and perceive no other brand as good enough.
- Brands make price comparison with competing products more difficult and, to a certain extent, protect the retailer against self-destructive price wars. If the consumer wants only the Miele or SMEG brand, for example, he or she will not easily buy a cheaper substitute. Price competition is therefore obviated.
- Brands are an inseparable part of the product image and offer the marketer the opportunity of creating the product image. Consider, for example, the association created by the brand name Audi and the four interlocking circles in the mind of the everyday consumer.
- Brands make product differentiation possible and enable the marketer to distinguish his or her product from competing products.
- Brands facilitate the expansion of existing product ranges because consumers tend to accept new additions to an existing range more readily than an unknown product item that is not part of a range. A case in point is the success of BMW’s smaller car (the 1 series) in the market.

In fact, in a competitive market, it is almost impossible to market a consumer product successfully if it has no brand identification. These days, attempts are increasingly being made to brand products that traditionally have not had brand names, such as milk (Parmalat) and bread (Albany), to reap the benefits of brand identification.

The manifestation of brand loyalty is closely related to the advantages offered by the use of brands.

13.11.4.3Brand loyalty

Brand loyalty occurs when consumers show loyalty to certain brands. It is the result of good product quality, proven usefulness and repeated marketing communication. A brand that does not meet consumer demands runs the risk of losing the battle against competing brands. A brand that is not introduced properly to consumers will remain unknown and therefore unloved. The consumer gradually moves through three phases of loyalty:

1. **Brand recognition**. Consumers recognise the brand and know what it stands for.
2. **Brand preference**. Consumers prefer the brand to other competing brands.
3. **Brand insistence**. Consumers insist on the specific brand and refuse to accept a substitute.

Marketers naturally aim at achieving brand insistence, because this gives the product speciality value in the eyes of consumers. The consumer will shop around until he or she finds the branded product. In such a situation, a competitor will find it difficult to gain a foothold in the market. However, the marketer still has to advertise the brand and bring it to the attention of consumers, even at this stage. An example would be the customer insisting on purchasing a specific whisky brand like Johnny Walker instead of considering other brands that may be cheaper.

In a later section of this chapter, the strategic marketing discussion will refer to the need to maintain long-term relationships with consumers and clients. Brand loyalty is the result of such a long-term relationship. Brand loyalty is possible only if the marketing concept is strictly adhered to.

13.11.4.4 Manufacturer, dealer or generic brands

Manufacturers usually give their own brands to the products they market – for example, Nike. Large **retailers** or **dealers** also often buy unmarked products from manufacturers and give these products their own brand names. For example, Edgars has different ranges for different market segments, like Kelso for younger active and professional women, Free 2bu for teens and young adults (hip fashion wear) and Stone Harbour for larger-sized men. Then there are the **generic brands**, the so-called no-name brands. The branded products of manufacturers compete directly with dealer and generic brands in what is referred to as the 'battle of the brands'. It remains to be seen which type of brand will become the most popular.

A **manufacturer** should decide whether it wants to market its products bearing its own brands or, instead, market unbranded products directly to dealers. Sometimes large manufacturers have excess manufacturing capacity that they utilise to produce unmarked products for dealers. In such cases, there should be clearly distinguishable market segments at which the market offering can be directed. If this is not the case, the dealer brand will only aggravate the competitive situation by making inroads into the market share of the manufacturer (in other words, cannibalisation of the manufacturer's brand). We can compare the divergent characteristics of the three brands mentioned above in terms of the general marketing mix decisions:

- Manufacturer brands are for the quality-conscious brand loyal buyers. They tend to have wider and deeper ranges with high-quality differentiated brands. The price is usually higher and controlled by the manufacturer, and the brands are available at larger retail outlets. Marketing communication is the responsibility of the manufacture. An example is Nike.
- Dealer or house brands are far more price conscious consumers, and loyalty is built for the retail owner of the brand. The quality and design are often the same as a manufacturer brand, but ranges are more limited and awareness is less, as it requires consumers to know the retail owner. This means that pricing, channel and

communication are controlled by the retail owner of the brand. An example would be Kelso in ladies' fashion, which is owned by Edgars, and the Secret Cellar range of wines owned by the Ultra Liquor chain.

•Generic brands are aimed at price conscious consumers who are willing to accept a slightly lower quality, such as consumers with large families. The product range is more limited, and usually at lower quality. There is less emphasis on packaging, and the labelling identifies the product content rather than a brand or store brand. Pricing is usually controlled by the retailer and promotion is often limited to point-of-sale only.

13.11.4.5Individual/family brands

Marketing management also has to decide whether it is going to choose an **individual brand** for each product item (for example, Lux, Dove and Knorr from Unilever) or whether it is going to use a family brand (for example, Heinz Baked Beans, Heinz Soup and Heinz Tomato sauce) for the whole range of products. Both decisions have advantages as well as disadvantages.

If a family brand is chosen, the costs of introducing a new product in the range into the market are lower. Spending on marketing communication usually decreases, because consumers are already familiar with the name of the products in the range. The new product can also benefit from the popularity of the other products. The reverse is also true: if one product in such a range performs poorly, the reputation of the other products bearing the same name is damaged. Individual brands are expensive to market because separate marketing communication attempts have to be made for each individual product. An individual brand requires another name, offering the opportunity for originality and aggressive marketing attempts aimed at specific target markets.

13.11.5Packaging decisions

Packaging can be described as the group of activities concerned with the design, manufacturing and filling of a container or wrapper with the product item so that it can be effectively protected, stored, transported and identified, as well as successfully marketed.

Packaging should be designed so that the product can be handled without damaging the quality of the contents. It is even more important that packaging should promote product sales. The consumer should be able to distinguish the packaging standing on the shelf from the packaging of competing products. The packaging therefore usually has a label bearing the characteristic brand and other important information. Bright colours and striking designs are used on packaging to attract the consumer's attention. The brand-loyal consumer, for example, will recognise from a distance the characteristic packaging of the detergent he/she buys regularly.

13.11.5.1Different kinds of packaging

Marketing management usually devotes a great deal of attention to choosing packaging and a packaging design that will show off the contents in the best possible way. The different kinds of packaging that can be chosen are the following:

•**Family packaging**. All the products in the range are packed more or less identically. The same packaging material is used, and the sizes of packaging are more or less the same. Family packaging is usually related to family brands. (There are, however, exceptions, as in the case of beer, where each kind has an individual brand, but all have more or less similar packaging.) Pantene shampoo, for example, is sold in identical bottles but with various labels to indicate the contents. Family

brands can facilitate consumer decision-making because the packaging is easily recognisable. It can, however, also be a source of irritation. The consumer may purchase a product that he or she does not really want if the labels and colours resemble each other too closely.

• **Speciality packaging**. This gives an image of exclusivity to the product. Perfume, jewellery and expensive liquor (for example, the distinctive triangular boxes of Toblerone Swiss Chocolates) are often sold in speciality packaging. Such products are popular gifts.

• **Reusable packaging**. This creates the impression that the consumer receives a 'free' container if he or she buys the product. The container can be reused for something else later. (An example is the metal container in which Ouma Rusks are sold. The container can be used to store rusks, biscuits and future packets of Ouma Rusks. Ouma often reissues this pack as a special edition package). Reusable packaging leads to repeat purchases because consumers tend to collect the containers. The danger is that consumers may stop buying when they have purchased enough containers or if they are reluctant to throw them away when the containers are empty. Bokomo rusks has launched a rusk range in a reusable plastic container to compete against the powerful Ouma rusk brand.

How product packaging can help to boost sales

Many consumers aren't aware of the extent to which packaging influences their purchasing choices. Businesses of all sizes place a focus on how their products are packaged because packaging is consumers' all-important first contact with the products they buy. So, it is crucial that packaging attracts consumers to products.

The graphics on product packaging are carefully designed to evoke emotions and feelings in the people who are considering buying them. For example, photos of people who are just like you can make you feel empathy towards other users of the product, and to identify with them and buy the product. Bright, cartoon-style graphics attract children to products. And different colours on packaging mean different things to consumers: red could mean excitement and action, for example, and blue could mean calmness and relaxation.

Consumers initially view and handle the product in its packaging, so packaging often helps them to decide which product to buy when they are faced with a choice. So, product packaging becomes an extension of the product in the way in which it represents the product. Consumers aren't always consciously aware of this function of packaging.

Expensive packaging can also increase the price of a product, so marketers need to be aware of what their packaging and its quality says about the products they sell. Expensive packaging suggests a better-quality product than cheaper packaging.

Marketers also need to understand their competitors' packaging. This can guide them to decide which quality of packaging they need to use to compete, and how to design their packaging to stand out from their competitors' packaging.

Packaging will not hold a consumer's attention for very long. So, marketers need to ensure that their packaging has an emotional effect on consumers within a few seconds.

It is important for packaging not only to look good, but to work properly too. If a product is easy to open, use and store in its packaging, for example, consumers are more likely to buy the product again. If consumers struggle with the product's packaging in the course of using the product, however, they will likely try a competitor product in future.

Sources: Adapted from Smart Marketing. n.d. How can packaging increase sales. Available at http://www.smartmarketingthailand.com/blog/how-can-packaging-increase-sales/. [Accessed 16 May 2019]; Chron. n.d. Packaging effects on marketing. Available at http://smallbusiness.chron.com/packaging-effects-marketing-61726.html. [Accessed 16 May 2019].

13.11.5.2 Choice of packaging design

When it comes to the choice of the packaging design, marketing management has to decide on the kind of packaging material, the shape and size of the packaging, and the graphic design on the label.

The packaging materials (for example, glass bottles, cans, cardboard boxes or plastic tubs) best suited to the product are chosen. Glass bottles containing bottled fruit are more attractive than cans, for example, but they are impractical to transport and usually more expensive. Marketers often choose different and better types of packaging material than their competitors in an attempt to differentiate their products from competitors' products. An example is the variety of packaging used for certain types of liquor, with each item in a different type of bottle.

The shape of the packaging or container may have a specific functional value, such as reusable plastic tubs for margarine or the Bokomo rusk packaging mentioned above. The shape may also have a symbolic value, which may subconsciously influence buyers. A square shape is supposed to have male connotations, whereas female consumers prefer flowing and round shapes. These types of 'male' and 'female' shapes for packaging are especially noticeable in the case of toiletries.

Characteristic packaging helps consumers to recognise the product on the shelf, even from a distance. This explains why it is not desirable to change packaging without informing consumers properly. This does not mean that containers should never be modified. Changes are often made in the shapes of packaging and printed matter or labels, either for the sake of improvement, or for functional or aesthetic reasons. Just think how many times the word 'new' is used in combination with a new kind of packaging. The product is then advertised in its new packaging to educate consumers about the new look of the packaging.

Innovative packaging: The Coca-Cola PlantBottle

Coca-Cola's PlantBottle programme represents a breakthrough in CPG packaging innovation that makes use of renewable resources and that is 100 per cent compatible with existing packaging recycling setups.

This new packaging looks and feels the same as the regular plastic bottles but, using an environmentally friendly, renewable, plant-based manufacturing process, PlantBottles are aligned to existing PET recycling programmes, leading to a smaller carbon footprint.

Fahrenheit 212 worked with Coca-Cola's global packaging team to translate complex and contentious advances in polymer production into a clear and compelling consumer proposition. The PlantBottle brand name evolved from the concept development and strategic positioning work undertaken by Fahrenheit 212. The first PlantBottle prototype was released in 2009 and it has since been distributed in more than 35 billion bottles in nearly 40 countries.

This innovative packaging has resulted in eliminating almost 100 000 tons of CO2 emissions (the equivalent of over 200 000 barrels of crude oil). The plant material used to make part of the plastic component is being sourced from sugar cane while the traditional PET bottle is made from 100 per cent fossil fuels and has a higher carbon footprint. On average, PET manufacturing can produce about three tons of carbon dioxide (CO2). Approximately a third of the PlantBottle is replaced with this natural, plant-based material.

Coca-Cola announced in 2012 that it has set a goal to use this durable PlantBottle packaging technology for all of its plastic bottles by 2020. Coca-cola learned that packaging can be used as a marketing tool, that the cost objectives are hard to attain and are seen as an end goal, but that working with other collaborators and external partners helps in driving innovative sustainable solutions in packaging.

Sources: Adapted from Fahrenheit 212. n.d. Coca-Cola PlantBottle: Defining the consumer proposition for bio-PET. Available at http://www.fahrenheit-212.com/coca-cola-plantbottle/. [Accessed 14 August 2015];

Petronzio, M. 2015. Coca-Cola's new bottle is made only from plants. Available at http://mashable.com/2015/06/09/coca-cola-plantbottle/#cLzxmOMEg5qw. [Accessed 27 May 2016]; Kariuki, D. 2015. The PlantBottle – new plastic bottles made completely from plants. Available at http://cleanleap.com/plantbottle-new-plastic-bottles-made-completely-plants. [Accessed 27 May 2015]; Heritage Pioneer Corporate Group. n.d. What is the Coca-Cola PlantBottle? Available at http://www.hpcorporategroup.com/what-is-the-coca-cola-plantbottle.html. [Accessed 27 May 2016].

Packaging sizes are important in that marketing management has to retain the sizes traditionally used in the industry to save money, but in doing so has to forgo the competitive advantage of unusual sizes. Products packaged in unusual sizes draw the consumer's attention, but at the same time make price comparisons difficult.

The label differentiates the product from other similar products, especially if containers have been standardised.

The label also serves as the carrier of the marketing message. The colours on the label and the graphic design (letter types and illustration) help to attract and hold the consumer's attention.

13.11.6 Product differentiation

Marketing management also has to decide on the way in which the product should be differentiated from other competing products. Product differentiation means that a business distinguishes its product, physically and/or psychologically, from essentially identical competing products, so that the product is regarded as a different product by consumers in a specific target market. Physical and psychological differentiation can take place on the basis of design, quality, colour, taste, size, brand, packaging or any other distinguishing feature, such as price, the marketing communication message or the type of distribution outlet. One of the best examples of differentiation is found in the car market when a new model is added to the range to differentiate the product from competitors' products. Another example is how McDonald's uses its wide range of products to reach a wider market range. These products include salads for consumers opting for a healthier choice or the breakfast menu for those who prefer breakfast on the move.

Different kinds of differentiation

- **Differentiation by means of packaging and brand**. The various types of margarine in the market are distinguished by the use of different types of packaging, such as plastic, foil or waxed paper, the brands, the designs on the labels and the colours used.
- **Differentiation by advertising appeals**. Advertising appeals for one brand of detergent emphasise the 'enzyme-active ingredients'. For another detergent, the 'stain-removing powder' is underlined and for yet another detergent, the advertising appeals focus on the 'clean, fresh smell'.
- **Differentiation on the basis of price**. There are big differences in the pricing of cosmetic products, for example Revlon products cost much less than Estée Lauder products.
- **Differentiation on the basis of distribution outlet**. Rolex watches are available only at the biggest and best-known jewellers.

13.11.7 Product obsolescence

An important product decision concerns product obsolescence. A product may intentionally be made technically and/or psychologically obsolete in order to compel the consumer to make repeat purchases. At the technical level, products can be designed to have a specific lifespan. An example is Duracell batteries. Psychological obsolescence points to the introduction of a new model or style, resulting in the

consumer rejecting the 'old' product, which may still be completely effective technically. New car models and new fashions are well-known examples of planned psychological obsolescence.

The strategy of planned obsolescence is often criticised because it leads to the waste of scarce resources and aggravates the pollution problem. However, the fact remains that new models are usually technically better than the earlier ones, thereby contributing to greater consumer satisfaction. Planned obsolescence also contributes to economic progress and job creation. An interesting example of planned obsolescence is the Toyota Hilux, which relaunched with a new body design and improved features that revitalised the brand.

13.11.8 Multi-product decisions

Marketing management also has to make decisions on the composition of the product offering (see Section 13.11.1). A business seldom manufactures and markets one specific product item only. The product offering usually consists of a product range or even a diversified variety of product items and ranges. The total product offering of a business changes continually. Profitable opportunities occurring in the market are utilised through the development of new products or by takeovers of existing businesses including, naturally, the product items and ranges marketed by those businesses.

Multi-product items in the total product offering reduce the risk of failure and financial loss because the success and profit of one product item can compensate for the poor performance of another product item.

13.11.9 New product decisions

Product decisions also have to be made about the development of new products. Each product starts its life as an idea, conjured up by someone. A sales representative, a dealer, a technician in the manufacturing division or a consumer may suddenly get an idea about a product that will meet specific consumer needs, and that the business should be able to manufacture and market. Successful large businesses often have new-product venture teams, consisting of various functional experts who actively and constantly seek new ideas for new products. In such businesses, top management usually encourages staff to come forward with product ideas. The idea for a new product may be unique and original (an innovation). The product may also be 'new' only in the sense that it is an improvement on, or a modification of, an existing product. The risk of failure and financial loss is usually greater with the marketing of an innovation – a unique, original product – but the possibility of releasing higher profits is also greater. Consider, for example, the introduction of the iPhone and the price charged for this innovative product.

New product development is planned and executed step by step, and the new product idea goes through various phases until the product is eventually introduced into the market. The phases of new product development are as follows:

- **Phase 1:** Product ideas are developed.
- **Phase 2:** Product ideas are screened according to financial criteria, for example, sales projection and profitability analysis.
- **Phase 3:** Product ideas that do not appear to be viable (profitable) are eliminated.
- **Phase 4:** Physical product development is done by the manufacturing division and a prototype is manufactured.
- **Phase 5:** The marketing strategy is developed. This strategy entails:

»positioning of the product in the market;
»choice of brand;
»design of packaging;
»compilation of the marketing communication message;
»decision on price; and
»choice of a distribution outlet.

•**Phase 6:** Test marketing takes place in a specific small segment of the market – for example, in Port Elizabeth only – to test the market's reaction.

•**Phase 7:** The product is introduced into the market.

Each of the seven phases is preceded by intensive research and several factors can lead to the demise of the product idea. Nonetheless, the continual generation of product ideas remains a priority, for the survival and progress of a business are closely linked to the success achieved by the business in this field.

The introduction of a product into the market (phase 7) is the first phase in a product's life cycle. All four of the phases in a product's life cycle and the integrated marketing strategy during each phase are discussed in the next section.

13.11.10The nature of the product's life cycle

The product's life cycle, as shown in Figure 13.8, is indicated as a curve in respect of which sales or profits are indicated on the vertical axis and time duration is indicated on the horizontal axis. Four phases are indicated:

1.The introductory phase
2.The growth phase
3.The maturity phase
4.The declining phase.

Figure 13.8 also illustrates the sales and profit curves during the four phases of the product's life cycle.

The sales curve ascends during the introductory and growth phases, reaching a peak in the maturity phase, and then levelling off (stagnating) and descending during the declining phase.

The profit curve looks similar, but starts rising only later in the development phase. The reason is the high costs related to new product development. Costs first have to be recovered before any profit can be made.

The profit curve starts to decline earlier than the sales curve. This is because the product meets keen competition in the maturity phase, causing a price cut (thereby lowering profits).

The marketing communication costs normally rise in this phase, since competition necessitates stimulation of demand. The increased costs naturally affect profits. Marketing management's objective is to sustain the profitable phase of the life cycle for as long as possible. This can be done by constantly modifying the integrated marketing strategy. The declining phase should, at all costs, be avoided.

The curve in Figure 13.8 illustrates the traditional life cycle of a product. Obviously, not all products have identical life cycles. Where an enterprise, for example, markets a whole range of products, each product has its own life cycle. Figure 13.9 illustrates the different life cycles. Although the seven cycles differ, each one reflects a rise, a peak, a stagnation and, in most cases, inevitably a decline. In each of the life-cycle phases, the decisions regarding the price, product, distribution and marketing communication are adjusted. This integrated marketing strategy during the different life-cycle phases is discussed in section 13.11.11.

Figure 13.8: Phases in the product's life cycle

Figure 13.9: Different product life-cycle patterns

Source: Cant, M.C., Van Heerden, C.H. & Ngambi, H.C (Eds). 2013. *Marketing management: A South African perspective*. Cape Town: Juta, p. 209; Du Toit, G.S., Erasmus, B.J. & Strydom, J.W. (Eds). 2010. *Introduction to business management*. Cape Town: Oxford University Press, p. 396.

13.11.11 Marketing strategy during the product life cycle

It has often been stressed that the four marketing instruments have to work together as an integrated whole. They cannot function in isolation. It is marketing management's responsibility to achieve this unity because of the numerous variables and because the marketing instruments not only complement each other, but are also mutually interchangeable. The discussion that follows will show how the four marketing instruments can be combined in an integrated marketing strategy during the product's life cycle.

13.11.11.1 Integrated marketing strategy in the introductory phase

The integrated marketing strategy entails the following in the introductory phase:

- **Objective**. The objective is to create a demand. A demand for the product has to be created in the first place because at this stage, consumers are not aware of such a new product (for example, the demand for the Netflix television streaming product).
- **Target market**. The target market consists of consumers who are adventurous and prepared to try out new things and run risks, for it is possible that the new product may be a great failure.
- **Product decisions**. The product decisions that are taken during product development are implemented (for example, the shape and size of the product).
- **Distribution decisions**. These involve exclusive or selective market coverage. Only a few shops will be prepared to allocate shelf space to the new product.
- **Price decisions**. A high initial price (skimming price) is fixed, since a new product (innovation) usually has a certain degree of prestige value.
- **Marketing communication decisions**. Initially, the business relies heavily on personal selling to dealers. Full-page colour advertisements appear in the more prestigious speciality periodicals. The sales message may contain highly technical information. Publicity is obtained fairly easily because the product usually has news value. Sales promotion techniques can be used to attract attention to the product.

3.11.11.2 Integrated marketing strategy in the growth phase

The integrated marketing strategy entails the following in the growth phase:

- **Objective**. The objective here is to develop a demand. The demand for the specific brand has to be created. At this stage, there are several competing products on the market and the target market is no longer unfamiliar with the product.
- **Target market**. The target market consists of consumers who are less receptive to new things and new ideas. They first want to establish whether the innovators approve of the product.

•**Product decisions**. Minor product modifications are made. The brand is emphasised.
•**Distribution decisions**. This involves selective market coverage.
•**Price decisions**. The price declines because of competition.
•**Marketing communication decisions**. Advertising occurs through the mass media, such as newspapers, radio and television. Sales promotion methods are utilised. All of this is done to promote the specific product and the brand name.

13.11.11.3 Integrated marketing strategy in the maturity phase

The integrated marketing strategy entails the following in the maturity phase:
•**Objective**. The objective is to counteract competition and prolong the life cycle of the product.
•**Target market**. New target markets are sought and exploited because marketing management is aiming at a large market share. Most consumers are aware of the product and its benefits.
•**Product decisions**. Modifications or improvements have to be introduced to differentiate the product from numerous similar products on the market. (Product differentiation is discussed in section 13.11.16). All four marketing instruments should help to achieve product differentiation. If this is successful, the product will be perceived as unique by a specific target market. In such a favourable situation, little direct competition will be encountered, even though the product is in the maturity phase. Other product decisions that should receive attention in this phase are the development of new products, extending the product range and product obsolescence. A new product or model starts its life cycle again in the introductory phase.
•**Distribution decisions**. There is intensive market coverage. All suitable dealers with the required facilities are allowed to stock and sell products.
•**Price decisions**. The current market price or market price level should be adhered to unless marketing management has succeeded in differentiating the product successfully. The product is then accepted as unique. Marketing management has price discretion because the consumer perceives the product as unique and does not mind paying more for it.
•**Marketing communication decisions**. There is persuasive advertising through the mass media. The sales message is less technical and more emotional than during the introductory phase. In a television advertisement, for example, children might portray an expression of love for their parents because they have bought them a certain cellphone brand. This type of emotional appeal is often the most important way of differentiating a product from competing products in a highly competitive market.

13.11.11.4 Integrated marketing strategy in the declining phase

The integrated marketing strategy entails the following in the declining phase:
•**Objective**. The objective is either to maintain the market share or to withdraw the product.
•**Target market**. The target market consists of an older, more conservative group of consumers who resist change and avoid innovation.
•**Product decisions**. No modification of the product is considered. Attention is paid to the development of substitute new products or models. The obsolete product is eventually withdrawn from the market.

- **Distribution decisions**. There is limited market coverage and this coverage occurs only in areas where the product is still in demand.
- **Price decisions**. Prices are reduced and the product is offered on sales.
- **Marketing communication decisions**. There is personal selling and advertising only in areas where the product is still in demand.

13.12 Price decisions

13.12.1 The meaning of price

Price may be regarded as the exchange value of a product or service, and it is closely linked to concepts such as benefit and value. The value of a product or service is determined by its benefit to the consumer, and the sacrifice required in terms of money and effort to obtain the product.

Owing to the following factors, it is difficult to describe the concept of 'price' and its meaning:

- The marketer and the consumer attach different meanings to the price concept. Marketing management regards price as one of the marketing instruments used to achieve a business's objective. For the consumer, the price he or she pays for a product entails a sacrifice of disposable income. The final price usually represents a compromise between the seller (marketer), who wants to receive as much as possible, and the consumer, who wants to pay as little as possible.
- It is often not possible to specify a single price for a product because of the large number of products, the geographical distribution of consumers and segmentation of the market.
- Price is only one of the four marketing instruments. Should any modification be made to any of the other marketing instruments, costs also change, necessitating a price adjustment. The product price, therefore, cannot be fixed without considering the influence of the other marketing instruments.

The question now arises as to how the problems mentioned above can be solved, making it possible to determine the final price of a product in such a way that both the marketer and the consumer are satisfied. The answer lies in the process of price determination. It is important to note that technology and the Internet have made the process of price comparisons much easier for consumers, with many price comparison engines available across a number of product categories. An example of this in South Africa is the Hippo insurance comparison engine (see https://www.hippo.co.za/) which allows a consumer to quickly compare the prices of a number of insurers for a specific car.

13.12.2 The price-determination process

The price-determination process consists of four phases:

- **Phase 1: Determination of the cost price**. The first step in determining the price of a product is the responsibility of the cost-accounting department and not of marketing management. The unit costs to manufacture and market the product are calculated. The product price cannot be lower than cost because this would entail financial loss, which could ruin the business.
- **Phase 2: Determination of the market price**. The market price is the price the consumer is prepared to pay or the current market price at which competing products are sold. It is marketing management's task to determine the market price. This can be done by launching a market-research project involving consumers or

dealers. A survey of the prices of competitors' products can also be undertaken. If the cost price is much higher than the market price, a cost-reduction adjustment has to be made or marketing management has to make a special attempt to convince consumers that the particular product warrants a higher price.

- **Phase 3: Determination of the target price**. The target price is the price that will realise the target rate of return, taking into consideration the cost structure, the business's capital needs and the potential sales volume of the product. One way of calculating the target price is the cost-plus method. This is done by adding the profit margin to the unit costs of the product. The accepted rate of return determines how large the profit margin will be.
- **Phase 4: Determination of the final price**. This price is the price at which the product is offered to consumers. It is determined through a reconciliation of the market price and the target price. The final price therefore lies somewhere between the market price and the target price. For example, if the market price of an article is R20,00 and the target price is R18,50, then the final price may be set at different levels between R18,50 and R20,00. For various reasons, the final selling price cannot be adjusted further.

13.12.3Adaptations of the final price

13.12.3.1Skimming prices

If the product is an innovation and therefore a unique new product, the final price may have a much higher profit margin. Some consumers are prepared to pay the high price because such new inventions usually have prestige value. In fact, if the price is set too low, consumers could possibly doubt the new product's usefulness. For example, electric shavers were priced too low when they were first put on the market. They started to sell only once the price had been almost doubled.

Yet another reason for an innovation to have a high initial price is that marketing management has to recover development costs before a profit can be made. It has already been pointed out that the development of a new invention is an expensive process with great attendant risks. As the product gains popularity, the high initial price can gradually be reduced. The more units that are produced and sold, the lower the costs will be, with the result that the price drops. Of course, competitors find high profits tempting, which mean that marketing management cannot maintain a skimming price for a long time in the face of new competitive products.

13.12.3.2Market-penetration prices

Marketing management may decide against setting a high skimming price and rather set a **market-penetration price**. Here the initial price of a new product is lower, and the marketer hopes to penetrate the market rapidly, discouraging competitors in the process. Competitors may decide that the small profit margin is not worth the effort of marketing a competing product themselves. An example is the Nintendo Wii that was priced much lower than its competitors when first launched, which at the time led to it having the largest market share among its competitors.

13.12.3.3Market-price level

This strategy is followed if there is keen competition and numerous similar products have to compete against each another. In such a situation, marketers have to maintain the market price. If they set the price of their product higher than the price of their competitors' product, consumers will tend to avoid it. If the price is lower than the prices of competing products, consumers will think there is something wrong with the

product. Marketing management can escape the limitations of the market-price strategy only if its product is successfully differentiated and is therefore regarded as unique.

13.12.3.4 Leader prices

Leader pricing concerns special offers. These so-called specials are used by retailers to lure consumers to their shops. Purchasers purchase the low-priced ‘specials’ as well as many other products with a higher profit margin. A very small profit is made on leader-price products. These products are sold at a price lower than the current market price for a limited period only. Manufacturers do not usually like leader pricing. Even though they can sell more products, the profit margin is inadequate and, later, when competitors’ products are selected as a leader-price item, sales figures drop. If manufacturers are not prepared to lower their profit margins so that their products can be sold as special offers, the retailer refuses to give them shelf space, giving preference to competing products. The manufacturer is in an unenviable position if the retailer is so large that, as channel captain, the retailer can enforce leader prices. (The question of channel leadership is discussed in greater detail in section 13.13.)

13.12.3.5 Odd prices

Odd prices indicate that the final prices of products have odd numbers. Even prices (for example, R6, R10 and R20) are avoided, and products are rather marked R5,99, R9,79 and R19,95, for example. It is thought that consumers are more likely to accept odd prices and that an odd price looks smaller than an even price.

13.12.3.6 Bait prices

Bait prices are unethical and are therefore avoided by honest retailers. A bait-price item has a particularly low price and is widely advertised. When coming to buy it, purchasers are encouraged to buy a far more expensive item. The retailer does not really intend to sell the bait-price item. Most of the time, it is not even in stock or only one item is available at the low price.

13.13 Distribution decisions

13.13.1 Description of distribution

In an earlier section, marketing was explained as being those activities that have to be carried out to direct the flow of products and services from the business to the consumer in such a way as to satisfy the primary objective of the business and meet the needs of the consumer. It is clear from this definition that a flow or transfer process takes place. Distribution plays an important role here. The transfer takes place along specific distribution channels, which consist of intermediaries (wholesalers and retailers) who are involved in the transfer of products from the manufacturer to the consumer. It is the task of marketing management to link the manufacturer and the various intermediaries in such a way that the product is made available to the consumer in the right place and at the right time.

Distribution entails decision-making about the type of distribution channel. It also entails decisions about the performance of certain activities – for example, physical distribution (also called logistical activities) such as transport scheduling and stock-keeping.

Later in this section, the various types of distribution channels, the question of channel leadership and the various types of market coverage will be examined. The channel leader or captain is the channel member who may decide which type of channel should be used to achieve the most effective transfer of the product. Distribution

decisions also demand that a choice be made regarding the degree of market coverage required.

13.13.2 The choice of the distribution channel

The first decision to be made in respect of **distribution** strategy entails the choice of intermediaries. Five different **distribution channels** are distinguished, as depicted in Figure 13.10.

Figure 13.10: The five alternative distribution channels

- **Channel 1:** This is also called the direct-distribution channel. Although the intermediary is eliminated, physical distribution activities involved in the transfer of products still have to be performed, in this case by the producer. An example is an artist who sells his or her products at a craft market. Manufacturers usually sell industrial products directly to other businesses such as factories, which use the products in their manufacturing processes. Door-to-door sales – for example, selling Tupperware – are also an example of direct distribution, as well as start-ups selling direct from the Internet.
- **Channel 2:** This indirect-distribution channel is found especially in large retail businesses that buy from manufacturers. Checkers, for example, is a large retailer that buys directly from manufacturers and sells to the consumer.
- **Channel 3:** This indirect-distribution channel is often found nowadays. Wholesalers may sell directly to the final consumer, provided these sales constitute less than 50 per cent of their total sales. Examples include Makro and Metro wholesalers.
- **Channel 4:** This is the classic indirect-distribution channel that is still regarded as the most effective by a large number of manufacturers. For example, wholesalers supply stock to the informal retailing sector, such as spaza shops in disadvantaged areas or supermarkets. These shops sell stock on to the final consumer.
- **Channel 5:** In this case, the first wholesaler is usually a speciality wholesaler, which obtains a specific product from numerous producers and then sells it to the second wholesaler, which sells it to the retail trade, which in turn sells it to the consumer. For example, the first wholesaler might be located overseas. This wholesaler would buy products from the manufacturer in that country and deliver them to a wholesaler in South Africa. This wholesaler would then deliver these products to a retailer.

The type of product, the type of market and the existing distribution structure determine which of the channels will offer the greatest advantages. If the product is perishable and the market is localised, direct distribution is the ideal method. A stall next to the road where a farmer sells fresh vegetables and milk, or a couple selling township food such as kotas, is an example of a situation in which advantages offered by a direct-distribution channel (channel 1) are utilised. If the product has to be handled and transported in bulk, and the market is such that consumers are widespread, the manufacturer probably has to depend on the specialised knowledge and facilities of intermediaries (such as the wholesaler and retailer, in other words, channel 4) to make the product/s available to consumers. The indirect channel is the ideal choice in such a case.

13.13.3 Channel leadership

Traditionally, the marketing division of a manufacturer of consumer products makes distribution-channel decisions and consequently decides which retail outlets should market the business's products. More recently, however, it is frequently the retailer (for example, Woolworths, Shoprite Checkers and Pick n Pay) who makes the decisions and therefore controls or dominates the channel. The business that controls or dominates the channel is known as the **channel captain.**

13.13.3.1 The manufacturer as channel captain

If the manufacturer or producer is the channel captain, specific intermediaries often have to be persuaded to distribute the product. The producer may persuade the intermediaries to create a demand for the product by directing intensive marketing communication messages at consumers. This is known as 'pull' because the product is 'pulled' through the channel by means of consumer demand. (The intermediary is obliged to stock the product because the consumer demands it.) An example of this was Shell Helix oil, which was launched by advertisements aimed directly at the consumer. The consumer asked the retailer to stock the product.

Intermediaries may also be persuaded to 'push' a product by actively encouraging sales of products in a store. They may be persuaded to do this by, for example, offering a high profit margin on sales. Demonstration material, shop competitions and special display shelves may also be supplied by the channel captain to encourage the push strategy. Most consumer products such as cooldrinks and coffee are marketed this way. In the marketing of groceries, where competition between different producers is particularly keen, there is often a battle for shelf space. A combination of push and pull is used by the manufacturer as channel captain to persuade the retailer to find shelf space for a particular item between other competing products. It is especially difficult to obtain shelf space for a new competing product. In this case, the manufacturer should create a demand for the new item (pull) by thoroughly informing the consumer about it through advertising. The retailer should then be expected to apply the required push strategy.

13.13.3.2 The retailer as channel captain

If the retailer has a network of branches, enjoys store loyalty and has adequate financial resources, it can take over the channel leadership and lay down its conditions to the producer. An example of this is the Pick n Pay store group, which can be seen as a channel leader. In such cases, the retailer can pull as well as push the product. The retailer advertises the producer's products, actively promoting its sales by granting a price discount to consumers or by means of special exhibits to attract consumers' attention. Special shelf space is also allocated to such products. It is understandable that manufacturers are not very happy with this state of affairs and would rather retain the leadership themselves. If the manufacturer succeeds in obtaining brand loyalty for its products, it is not easy for a retailer to take over the channel leadership. Consumers then look for the specific brand of products and tend to avoid stores that do not stock them. This means that a retailer can be the channel captain for only some of the products in its store.

Here are descriptions and examples of some of the different types of retailer in South Africa:

- **General dealers**. These stores are one of the oldest forms of retailer in South Africa. They offer a wide range of products and operate mostly in rural areas. They sell items ranging from coal stoves to bicycles to clothing to groceries.

- **Department stores**. These large stores sell products in departments – for example, women's clothing, homeware and children's clothing. This retailing format is on the decline in South Africa, mainly because of the introduction of category-killer stores (that is, a retailer – for example, Meltz – that wants to achieve merchandise dominance by creating narrowly focused, jumbo-sized stores).
- **Speciality stores**. These stores have a narrow but deep product range – for example, jewellery stores.
- **Chain stores**. These stores are similar shops that are found all over the country and are similar in layout and product range. They are centrally controlled by a head office. Edgars is an example of a chain-store group. The Edgars head office is situated in Johannesburg.
- **Supermarkets**. These stores operate on a self-service basis and sell mostly fast-moving consumer goods (FMCGs) and especially groceries. An example is Pick n Pay.
- **Convenience stores**. These stores are found all over South Africa. Examples are shops at petrol stations (One Stop, Shell Ultra City), which sell typical convenience products such as bread, milk, newspapers and cigarettes. They are open for extended periods, providing a service to the customer.
- **Discount stores**. These stores are renowned for a high stock turnover and low prices. They mostly sell shopping products. South African examples include Makro and Game.
- **Hypermarkets**. These stores are larger than supermarkets. In addition to FMCGs, they sell more durable products such as gas braais and garden furniture. They attract people from a large geographical area. South African examples include Checkers Hypermarkets.
- **Shopping centres**. Shopping centres are usually found on the periphery of large cities or in suburbs outside the central city. Shopping centres are large buildings that house independent retailers as well as some anchor stores that draw people to the shopping centre. Anchor stores usually include a supermarket, discount store and/or department store. South African examples are Woodlands Boulevard in Pretoria's eastern suburbs, Canal Walk in Cape Town and Fourways Mall in Johannesburg.
- **Mail-order stores**. As the name indicates, these stores sell by mail. For example, Leading Concepts markets its products by sending catalogues to consumers. People then order by mail. Many of these retailers have shifted to online retailers.
- **Internet stores**. These retailers work off the Internet, and often incorporate other media such as mobile technology. The biggest e-retailer in the world is Amazon (https://www.amazon.com/), while in South Africa a well-known competitor is Takealot (https://www.takealot.com/).
- **Informal retailers**. Owing to the uniqueness of the South African situation, there are also many informal retailers operating in South Africa. One of the best-known informal retailers is the spaza shop. The spaza shop is a form of a convenience store found in townships. The shop typically forms part of the home of the entrepreneur. Basic commodities such as bread, milk, cooldrinks and cigarettes are sold through these stores.

13.13.4 Market coverage

The number of intermediaries in the channel is directly linked to the type of market coverage being aimed at. Types of market coverage include intensive, exclusive and selective market coverage.

- **Intensive market coverage** indicates a situation where as many suitable and available intermediaries as possible are utilised, especially by convenience-product producers. An example is Coca-Cola, whose products are distributed through cafés, liquor stores, supermarkets, spaza shops, street vendors, and the forecourt stores at petrol filling stations.
- **Exclusive market coverage** results when a manufacturer purposely limits the number of people handling its product. Only a few intermediaries obtain exclusive rights to sell the product in a specific geographical area. The intermediaries undertake not to stock other competing products. This type of market coverage is found particularly in shopping and speciality products such as designer wear and cars.
- **Selective market coverage** refers to the selection of only those intermediaries that will distribute the product efficiently. Selective market coverage lies somewhere between intensive and exclusive market coverage, and can be used by manufacturers of convenience, shopping and speciality products. Medicine, for example, is distributed by pharmacies (chemists) because chemists are the ideal shops to do this efficiently.

13.13.5 Physical distribution

A further aspect of the distribution strategy is decision-making about the **physical distribution** activities that have to take place to make a product available to the final consumer. These activities, in order of their relative importance from a cost point of view, include:

- transportation;
- storage;
- inventory-holding;
- receipt and dispatch;
- packaging;
- administration; and
- ordering.

The purpose of the physical distribution function is to maintain a specific satisfactory level of service to clients at the lowest possible distribution costs. The optimal service level is that level above which an increase in costs incurred in respect of physical distribution activities will not result in a corresponding increase in sales.

Physical distribution is becoming increasingly important. In earlier times, management was under the impression that physical distribution consisted of transport scheduling only. However, more attention was paid to this function after managers realised that the effective performance of the physical distribution activities could mean large cost savings for the business and, in addition, could ensure that the product was in the right place at the right time for the convenience of consumers. The three main components of physical distribution are:

1. Selecting warehouses
2. Selecting the most suitable mode of transport
3. Selecting optimal inventory-holding levels.

A compromise between cost and service must be reached in all three components. The most effective performance of physical distribution activities ensures:

- the timeous and reliable delivery of orders;
- adequate inventory so that shortages do not occur; and

- careful handling of stocks to eliminate damage, perishing and breakage as far as possible.

Physical distribution activities are discussed in greater detail in Chapter 15. As far as marketing is concerned, close liaison between the marketing manager and the purchasing manager is required, and the marketing manager has to be involved in planning and decision-making. If this is not the case, the flow of products from manufacturer to final consumer could be seriously hampered.

Supply chain management

The Shoprite Group has created and continues to increase its strategic lead in the supply chain through its ongoing investment and recognition of the supply chain's strategic importance.

A highly sophisticated supply line services the group's outlets in 15 countries where the Group trades. Improved levels of product availability contributed to market share gains while the drive to reduce inventory levels, despite the growth in both sales and the number of outlets, is paying dividends. In its most basic form, the supply chain consists of strategically placed distribution centres linking the flow of product from vendors to stores at which customer demand ultimately drives the movement of product.

Information technology and a fleet of refrigerated and ambient trucks enable the movement of product and the flow of information. The Group prides itself in running a state-of-the-art distribution operation and becoming the first South African retailer to receive the much-acclaimed ISO 9002 accreditation for import and export handling. In 2018, the Group updated their accreditation from ISO 9001 to ISO 9001:2015.

Centralised distribution is now regarded as a competitive advantage for the Group, enabling it to stabilise supply lines in times when supplier service levels drop. By controlling its supply line, merchandise can be buffered, countering vendor out-of-stocks and volatile trading patterns while offering an opportunity to buy in against price increases. The desired result is, inevitably, consistently to allow customers to find the items on their shopping list – thereby keeping their custom and their loyalty. Controlling the whole supply chain has also made it possible to introduce a great many cost-saving efficiencies, thus providing the mechanism to drive prices down daily.

The Group's supply chain presents the opportunity to re-engineer its retail stores and improve its utilisation of space by dedicating the minimum area to storage and the maximum area to trading space.

Merchandise is delivered to stores by a variety of trucks and trailers based at distribution centres throughout the country. The fleet is owned by the Group and operates 24 hours a day, seven days a week. A highly sophisticated transport route planning and scheduling system optimises store deliveries and integrates the operations of the distribution centre and the transport division. This channel to market is not only environmentally friendly by reducing the number of trucks on the road, but it empowers small to medium-sized suppliers, who can now deliver to one point and avoid the need to heavily invest in either warehousing or vehicles.

The success of Shoprite in managing its supply chain is highlighted in their statement; a combination of controlling their own supply chain, investing in employee skills, investment in infrastructure, as well as value-added services to compliment the shopping experience are three keys to their success.

Sources: Compiled from information in Shoprite Holdings Ltd. n.d. Supply chain management. Available at http://www.shopriteholdings.co.za/GroupServices/Pages/Supply-Chain-Management.aspx. [Accessed 9 November 2015]; Shoprite Holdings Ltd. n.d. Supply chain management. Available at https://www.shopriteholdings.co.za/trade-partners/supply-chain-management.html. [Accessed 30 Jan 2019].

13.14 Marketing communication decisions

13.14.1 The nature of marketing communication

The consumer is removed from the manufacturer, intermediaries or point of sale in time and space. It is the task of marketing management to communicate with consumers, inform them and make them aware of the variety of products offered in the market. Consumers should also be persuaded by the marketing message to select and buy the producer's product time and again.

Marketing communication can be regarded as the process of **informing, persuading** and **reminding** the consumer. Marketing communication comprises six elements that can be used in a specific combination to communicate with consumers. These six elements are:

1. Advertising
2. Personal selling
3. Direct marketing
4. Sales promotion
5. Publicity
6. Public relations.

Figure 13.11 shows the elements of marketing communication. All six elements have to work together to convey the marketing message to the target audience. Marketing management has to decide on the best combination of the six elements. A marketing communication budget allocates funds to each of the six marketing communication elements. Within the restrictions of this budget, consumers have to be made aware of the business's market offering. They should be persuaded to select and buy product/s, and must be constantly reminded to buy the product/s again. A discussion of the six marketing communication elements follows.

Figure 13.11: Elements of marketing communication

13.14.2 Advertising

Advertising is a controlled and paid-for non-personal marketing communication related to a need-satisfying product and directed by a marketer at a specific target audience.

13.14.2.1 Advertising media

The advertisements that are shown on television or in the movies, broadcast on the radio or placed in magazines and newspapers are examples of advertising. A single placement of such an advertisement is very expensive, hence the need to pay careful attention to both the choice of the media used and to the marketing communication message. Marketing managers should be very sure that their messages will reach the target market (or target audience in this case), and that this audience will notice the message, understand it, accept it and react to it by repeatedly buying the same product.

Outdoor advertising on billboards, posters, bus stops and public-transport vehicles reaches consumers at a time when they are busy with other activities. This is also a good way of reaching a target market that does not read regularly or does not have access to television and the movies. An advertising budget, as part of the marketing communication budget, is prepared to indicate the percentages of the budgeted amount

that should be allocated to the various media. Obviously, market research is done to establish the way in which the target market can be reached most effectively.

13.14.2.2 The advertising message

The formulation of the marketing message in advertisements in the different media requires careful consideration. An advertisement in the print media generally consists of three main components: the heading, the illustration and the copy.

The **heading** is supposed to attract the consumer's attention and to deliver the main or most important appeal, or the reason why the product should be bought. The most important message is often repeated at the bottom of the copy. The headline and sub-headline are printed in big, bold letters to attract attention.

The **illustration** may be a drawing or a photograph, in black and white or colour. The illustration stimulates interest and invites the reader to read the **copy**, which contains information about the product and the need satisfaction that it can provide. Rational reasons (for example, petrol consumption of 8 km/l, in city traffic for the Fiat 500 car) and emotional reasons (such as a claim that a certain deodorant will have the effect of women falling all over you and the product will add to your masculine charm and attractiveness) for purchasing the product are given.

The product itself, including the package and the label, should also appear in the illustration. All the components of the illustration itself are chosen to transmit a symbolic message. Models are carefully selected to play a specific role. A homemaker might be chosen to transmit a message about the excellence of a new piece of DIY equipment, while a South African celebrity might be portrayed as a successful user of a specific hair conditioning shampoo. The intended target audience must be able to relate to or identify with the model in the illustration. (For example, it would be ineffective to use a female as a model for buying car polish). It is important, also, to achieve coherence in all three components. The headline, illustration and copy should not tell conflicting stories.

In radio advertisements, only words and sounds can be used to transmit the advertising message. Music is often used to reinforce the message or to create a specific mood. Jingles and slogans are especially effective in teaching brand names to potential consumers.

Television advertisements are effective because the spoken and written word can be used to spell out the message clearly. Pictorial material, music, jingles and other sounds can be used to reinforce the message. For this reason, television commercials are very expensive and every second counts. Advertisers cannot afford to waste time on irrelevant material. Sometimes television advertisers get so caught up in the entertaining storyline of the television advertisement that they forget what the most important message is: the brand name.

13.14.3 Personal selling

Personal selling is a verbal presentation of a product, service or idea to one or more potential purchasers in order to conclude a transaction. Sales representatives are used to inform buyers about a business's product/s and to persuade buyers, through face-to-face communication, to buy the business's products time and again.

Sales representatives of manufacturers visit other businesses and dealers, communicating the marketing message directly. In the same way, wholesalers' sales representatives can be used to visit retailers to try to sell the variety of products handled by the wholesaler. Personal selling between sales representatives and final consumers also takes place. This is known as door-to-door selling (for example, the

selling of Tupperware utility plastic containers and the selling of cosmetics from Avroy Shlain). Sales by shop assistants over the counter may also be regarded as personal selling, but normally the retailer does not see it in this light. Retailers usually regard shop assistants as people who help with the physical distribution of the product – that is, people who do not have to be trained in the art of selling.

Example

Cosmetic products are often sold on a door-to-door basis. Avroy Shlain, for example, succeeded in building his extremely successful business by training and motivating his sales representatives to sell his cosmetic products, bearing his own brand name, by means of personal communication.

13.14.4Direct marketing

Direct marketing uses advertising media (for example, radio and television) to communicate information about a product or service to customers, who can then respond by purchasing the product or service via mail, the telephone or the Internet. The benefit of direct marketing is that customers can do the buying from the comfort of their homes, resulting in greater shopping convenience. This benefit ties in with the notion of cocooning, which is prevalent in South Africa today. Cocooning implies that more and more customers create a cocoon in their home. Spending more time at home becomes part of their lifestyle. This is motivated by various factors, including the increase in crime. A recent study found that many Internet shoppers do recreational buying. They see this kind of shopping as a pleasurable experience.

Direct marketing has the following benefits:

- A long-term relationship can be developed with the customer.
- The message can be directed at a specific customer.
- A customer database can be developed.
- The results of a direct-marketing campaign can be measured directly.

A number of direct-marketing methods can be used. One example is the use of the Internet, where consumers correspond with an organisation such as amazon.com to order DVDs, CDs and books. All these products can now be ordered in electronic versions, so the choice of product format is also evolving. Another example is telemarketing, where organisations use the telephone to call the customer at home and offer him or her a product or service. Other examples are direct mail, which solicits the customer to order a product, catalogues that are sent to potential customers and direct-action/response advertising done on TV and in the newspapers, to which customers can respond by phoning and ordering products on a toll-free number. Verimark and Glomail are two South African companies that use direct marketing.

13.14.5Sales promotion

Sales promotion consists of those marketing communication methods that are not normally classified as advertising, personal selling, direct marketing or publicity, but that complement the other elements in trying to influence consumer behaviour. Examples of such methods are pens, caps, T-shirts and notepads displaying a brand name and a short sales message. Competitions, demonstrations and the handing out of samples (for example, a small bottle of TRESemmé deep cleansing shampoo) are also examples of sales promotions. For example, a premium is an extra item offered when a product is purchased or can be two of the same products sold for the price of one. An

example of a premium is McDonald's happy meals. You buy the meal and get a toy as a little something extra.

Sales promotions often have short-term objectives only, for example, to introduce a new product to the market. However, they are valuable methods because they reinforce the effects of the other marketing communication elements. For example, if a consumer has seen a supermarket demonstration of how a new vacuum cleaner makes tough stains on carpets disappear (sales promotion), he or she would possibly understand the television advertisement (advertising) better and find it easier to accept the message, especially if he or she has also read an article in a newspaper column (publicity) in which the columnist explained how the vacuum cleaner actually makes the tough stains on carpets disappear.

13.14.6Publicity

Publicity is the non-personal stimulation of the demand for a product or service of a business by making its actual current news value available to the mass media to obtain a favourable and 'free' media review of the business and its product.

Publicity also interfaces with the business's public relations function, which is discussed in the next section of this chapter. Should the business or its product receive favourable coverage in the press, on the radio or on television, the publicity (created by the activities of the public relations division) has a specific marketing communication value for the business.

The distinguishing feature of publicity is that the message to be conveyed should have a certain degree of news value for the audience. Consider, for example, McDonald's donating money to obesity research. This created a lot of publicity for the company itself and made people aware of the problem that affects society.

A further feature of publicity is that marketing management has no direct say in formulating the message because the editors of publications, for example, decide what they want to publish. It is therefore clear that publicity can have a negative effect. (Imagine the negative publicity a motor journalist would give a test car that broke down on a rural road.) Publicity is not always 'free', as is suggested in the definition. A business often has to spend large sums of money on favourable mentions in the press, on radio or on television. Businesses often sponsor sports events or donate large amounts of money to charity. By doing this, a business effectively shows its responsibility towards the community and, in addition, gets free mentions of its name or product in the media. Consumers who notice the hidden message are then more inclined to accept the marketing messages of such a 'good' business.

Marketing management should decide which sponsorships or donations could be of benefit to the product/s to be marketed. Top management sometimes decides on sponsorships that are of interest to the top managers personally, notwithstanding the nature of the product or market. In this way, funds are often wasted on matters that do not have sufficient positive marketing communication value and hence will not succeed in demonstrating social responsibility. Specific marketing communication objectives should also be set in respect of sponsorships. Some of the best-known sponsorships are related to sports, such as Standard Bank and cricket, Castle and Vodacom in rugby, and Toyota sponsoring the Kaizer Chiefs team.

13.14.7Public relations

13.14.7.1Defining public relations

Public relations entails decision-making to help an organisation's ability to listen to, appreciate and respond appropriately to those persons and groups whose mutually beneficial relationships the organisation needs to foster as it strives to achieve its mission and vision.

In the light of the discussion on the nature of public relations, the definition[21] that follows explains the main elements of the function. Public relations is the management function that establishes and maintains mutually beneficial relationships between an organisation and its publics. It is a deliberate, planned and sustained process of communication between a business and its publics for the purpose of obtaining, maintaining or improving good strategic relations and mutual understanding between the organisation and its various publics, both internal and external.

The most important elements of this definition of public relations are the following:

- **It is a deliberate activity**. An analysis of the definition given above shows that public relations is a conscious, purposeful activity of business management. Every programme is geared to realising clearly formulated objectives.
- **It is a planned activity**. It is not an incidental process, but an operation that anticipates events, and is prepared for problems and contingencies. It includes a conscious evaluation of all business activities and their influence on the business's image. The management of public relations should act proactively. It should be oriented to the future and should always be ready for any difficulty or emergency.
- **It is a sustained activity**. It takes account of the fact that the public is in a constant process of change, that people have short memories and that amid all the numerous matters competing for their attention, consumers easily forget a business unless they are continually kept informed about it. It therefore has a long-term dimension.
- **It is a communication process**. The term 'public relations' presupposes communication between individuals and businesses. Establishing communication channels, especially through the mass media, is therefore a responsibility of public relations. Public relations management needs to have the necessary communication skills to convey information to the business's various publics so that the members will grasp and accept the message, and ultimately respond as management wishes them to. This means that public relations management should include communications experts who, in addition to their knowledge of the principles of communication, should be familiar with the policy and activities of all the functional areas of the business. Public relations should therefore be part of top management.
- **It deals with publics, both internal and external**. A public is any group that influences the organisation or its operations. Internal publics – for example, employees and management – exist within the organisation. External publics exist outside the organisation. Examples of external stakeholders include unions, the media, the community, government, financial institutions and the general public.

Public relations entails creating and maintaining goodwill towards a business. It is clear from the definition that goodwill is the decisive factor. Ill will is something that everyone prefers to avoid, and this applies in business too. The matter of goodwill and ill will occurs in all environmental markets: consumer, labour and financial. Public relations management concentrates on obtaining goodwill and avoiding ill will in all these markets. It is also important to maintain and improve goodwill once it has been obtained. Sasol has had very good growth lately and has been a good performer in financial terms, yet the numerous accidents that have occurred at its plants have made analysts and governmental safety agencies less than enthusiastic about the performance of the company at times.

13.14.7.2 The public relations media

Communications media are the channels used to convey the communication message. The spoken word, the printed word, sight and sound symbols, the electronic word, images on the Internet and special events are examples of the communications media used by the public relations department to transmit messages. The McDonald's promotion strategy, for example, includes a vast use of media tools, television commercials, local radio, billboards and frequently promoting movies and television shows. The collaboration of all these media tools can help distribute the corporate message to its customers.

THE SPOKEN WORD

The spoken word is used in public relations and face-to-face communication. It is probably the most important method of communication in any business. Both communicator and receiver must speak 'the same language' for them to understand each other. In South Africa, effective communication is difficult because there are so many official languages, but even without a language problem, misunderstandings frequently occur because people interpret communication messages differently. This is why the choice of a suitable spokesperson is so important and why ordinary employees cannot be allowed to communicate freely with the media.

THE PRINTED MEDIA

Newspapers, magazines and company publications are important printed media for the written word. Receivers can read (and try to understand) the message, while carefully selected pictures (illustrations) are used to support and reinforce a non-verbal message. The main types of printed media include the following:

- **Newspapers**. There are many morning, evening and Sunday papers available in urban and most rural areas. They appear in different languages and are read by a diverse audience. News reports are rigorously selected, and it is by no means easy for public relations departments to get their press releases accepted. There has been a decline in readership in the South African mainstream press, which traditionally had a wealthy white readership, mirroring the trend in established newspapers in developed countries across the world. This decline is generally attributed to the growth of the Internet with more and more of those who can, choosing to find their news online instead of on the printed page. Many newspaper houses are trying to manage the mix of printed and online, and a mix seems to be the way to go forward.
  - In South Africa there has been remarkable growth of newspaper readership in the lower end of the market, due to the improvement in the living standards of South Africa's poorest communities, the major beneficiaries of change in this country. You can read more on this at http://www.mediaclubsouthafrica.com/culture/36-themedia/mediabg/73-press#ixzz5gFPYxV6g.
- **Magazines**. There are also a great number and variety of magazines. The following types normally appear weekly, fortnightly or monthly, and are aimed at particular readers:
  - General magazines with articles on a variety of topics of general interest and a wide public readership
  - Magazines aimed at a particular section of the public such as men (*Men's Health*) or women (*Elle, Fairlady, True Love*)

»Specialised publications for people who are interested in particular sports, or with specific interests (for example, health-conscious people like to read *Shape*, outdoor-oriented people read *Getaway*, people who like to work in the garden read *Garden and Home*).

»Professional journals read by academics, doctors, lawyers, farmers, engineers and so on (business people, for example, read *Forbes Africa*).

•**Company publications**. A wide range of publications are used, such as handbills, brochures, annual reports, news sheets, books, road maps, guides, directories, recipe books, posters, wall charts, photographs, pictures, pocketbooks, desk diaries and, in some cases, personal newsletters or circulars. Annual reports and newsletters constitute particularly effective ways of conveying news about a business and its activities. It is the job of the public relations department to issue such publications with the requisite input from other departments. The purpose of these publications is to obtain goodwill or to create a favourable corporate image.

SIGHT AND SOUND

The most effective method of conveying a message combines sight and sound. This method allows receivers to see what is happening while sounds (like words and their sound effects) support and reinforce the message. The following media are extremely effective communicators of sight and sound:

•**Radio and television**. Just as the public press is the most important medium for the written word, radio and television are the most important media for sound and picture communications. The public relations department can use radio and TV as communication media in three ways to transmit messages:

»It can present prestige advertisements, designed to build a business's image and to make its brands known to the public.

»It can provide news reports – for example, when there are notable achievements or when newsworthy events take place.

»A public relations officer might appear on news reviews or participate in discussion programmes in which newsworthy topics are discussed at length.

•**Films and videos**. Another way of bringing the activities of a business to the attention of the general public is to sponsor documentary films or videos, usually shown on television or as supporting features in cinemas. Sponsorship of films is not intended as a form of direct-sales promotion, but rather to create a positive and favourable attitude towards the business.

SPECIAL EVENTS

Visits, receptions, exhibitions and sponsorships are special occasions that present opportunities for communicating messages. The arrangements for such events are the responsibility of the public relations department. Crises that occur regularly and unexpectedly are also special events that make substantial demands on the expertise and communication skills of public relations practitioners. Special events include the following:

•**Press conferences.** Press conferences, usually organised and managed by the public relations department, are special events that afford the business an opportunity to communicate with the public through the mass media. Both the spoken word and the written word are used at these events. News reporters usually receive a copy of a specially formulated statement made by the spokesperson, after which questions are allowed. This is normally followed by a news report in the mass

media. The public relations officer responsible for addressing the conference must show diplomacy in fielding difficult questions and an ability to encourage further questions by offering positive answers. A press conference on television often causes amusement when an inept spokesperson has to answer embarrassing questions.

•**Visits to the business**. Visits are usually encouraged because they create opportunities for the business to give out information that will foster goodwill. There are usually set visiting times when employees and members of the public are conducted through the premises by somebody with sufficient knowledge of the business to be able to answer any questions.

•**Receptions**. Businesses often take advantage of a particular occasion to entertain a select group of people at a luncheon or cocktail party. This is usually accompanied by a speech informing those who are present about particular achievements or developments. This kind of occasion provides an opportunity for hosts and guests to meet and mix informally. Again, the primary objective is to further the image of the business rather than to promote sales, although increased sales may in many cases result from a favourable image.

•**Exhibitions**. Most large businesses have venues in their own buildings that are suitable for holding exhibitions. An exhibition may demonstrate the process a product undergoes through to completion, or which equipment or apparatus is used, or it may provide information, accompanied by photographs, of performances achieved. Practical demonstrations can also be given.

•**Crisis management**. Crises and other unforeseen events constitute threats to the continued survival of a business. The public relations department must have a crisis plan ready to manage any unfortunate event. A crisis can be caused by a strike, a fire, a big accident on the factory floor, fraud and theft, defective products that threaten danger and even loss of life to consumers, and a whole range of other unexpected and unwelcome events. The purpose of a crisis plan is to limit as far as possible the physical and financial damage caused by the event, and to protect the corporate image. A specially appointed crisis co-ordinator must also be responsible for the following, which relate to internal and external communications:

»compiling a list of persons to be informed about the nature of the crisis;
»training of telephone operators to answer enquiries in the correct way;
»appointment of a spokesperson;
»informing and training employees to act correctly in emergencies (an emergency number should be readily available); and
»formulating a message to prevent further possible damage caused by negative rumours.

After the crisis has passed, the public should be reassured that everything is back to normal. In handling a crisis, transparency and honesty should prevail. The Tiger Brand's listeriosis situation, the Ford Kouga product safety issue and the Sasol plant accidents are recent examples of companies that have had to manage a crisis.

THE INTERNET

There is no doubt that the interactive workplace (cyberspace, the Internet and the World Wide Web) has affected the way many businesses operate. One of the most important developments is the use of public relations tools on these channels. Examples of this are the use of podcasts, blogging, web sales, intranet operations and the use of the web to communicate with target publics. These electronic channels will become an

increasingly powerful communications tool for public relations practitioners. Seitel[22] identifies three reasons for this:

1. **An increasing consumer demand to be educated as opposed to merely being sold things**. Many consumers and target publics are better educated and know when someone is trying to oversell to them. Communications programmes should respond by using education-based information instead of blatant promotion. The Internet is a good example of the use of such information.
2. **Time is of the essence**. The need to move quickly is well known in business, but there is an even greater pressure to operate in a real time mode. The world has become a global village in which immediate communication is possible. The Internet and the instantaneous access it provides can be used by public relations practitioners to respond instantly to any emerging issues or market changes.
3. **An increasing need for customisation**. There are more and more choices available to consumers. Compare the limited number of television channels there used to be in South Africa with the current situation. Satellite television has exponentially increased the number of possible channels available to consumers.

This increase in choice means that consumers today have increased expectations. They expect a more focused approach that caters to their specific needs and offers one-to-one communication. Businesses will have to focus on ever-narrower target segments or audiences, and the Internet is the vehicle for doing this.

In businesses, electronic mail or email is an increasingly important channel for communication with internal publics or other employees. It has become the preferred choice over traditional print media or fax technology. The advantages of email are that it is more immediate and more interactive. Employees can provide feedback immediately to what they read or hear, and businesses can respond quickly to this feedback. Stormhoek Wine Estate has managed to crack the difficult overseas export market through its creative and innovative use of alternative media such as its Instagram site to influence the external environment and its external publics. Visit their site at www.stormhoek.co.za and see for yourself. McDonald's could release a viral campaign of its Code of Ethics on the internet that could include video clips of the inspection of its restaurants around the world, for example. A viral campaign is when the clip is sent by customers who forward it to each other, or even place it on a media platform such as YouTube to let anyone access it.

13.15 Customer service

13.15.1 Introduction to customer service

For any business to survive, it needs customers. Without excellent customer service, it will be difficult to generate loyalty. The Internet has resulted in customers becoming more aware of their rights and able to access more information quickly. This means that if they are not satisfied with a product or service, they know there is somebody else willing to provide for their needs. The conclusion can thus be made that companies who are not providing good customer service will not survive in the long term.

13.15.2 Defining customer service

In a broad sense, customer service is anything we do for customers that enhances their experience.[23] Customer service can be described as whatever the company does to add value to its products and services in the eyes of customers.

Customers have certain expectations from their contacts with companies and it is the responsibility of the company to know what its customers want and aim to provide them with excellent customer service. For a business to gain the loyalty of its customers, it needs to live up to its customers' perceptions of customer service.

Customer service can be defined in a number of ways. Some definitions are given below.

Customer service is the ability of knowledgeable, capable and enthusiastic employees to deliver products and services to their internal and external customers in such a way that it satisfies identified and unidentified needs of customers and ultimately results in positive word-of-mouth advertising and repeat business.[24] It is clear from this definition that employees form an integral part of the total customer experience and that it has a profound effect on the success of the business.

Brink and Berndt[25] define customer service as follows:

Customer service is the provision of service to customers before, during and after a purchase. Essentially, customer service is any back-up service that a company provides to customers to maintain their loyalty and to secure a sale. It must be kept in mind that it is not the actual service that is of importance, but rather the perceptions that a customer has of the service. Therefore, one should always try to see the overall service from the customers' point of view.

It is clear from the definitions of various authors that customer service is not a passing action but rather a concentrated and focused effort by all in the organisation. It should form an integral part of the company's total product offering, behaviour and business culture. Customer service does not stop – companies need continuously to redesign, tweak and improve their customer service. These changes need to keep pace with ever-changing customer needs and expectations.

13.15.3 Who is the customer?

Customers are not limited to those outside of the organisation. They include internal customers as well. Both of these customers – internal and external – are important to an organisation and need to be managed correctly as both impact or affect the organisation's customer service.

13.15.3.1 External customers

External customers can broadly be classified as those people who purchase the company's products (personally and online) and to whom we usually associate with having to deliver customer service. Generally speaking, they are the people with whom staff interact – face to face, by telephone or online – and who, by their actions, influence the perceptions of the organisation's customers, products and services. These customers are in a position to enhance the reputation of a company and can contribute to the expansion and growth of the company. In other words, they can have a profound effect on the success, or otherwise, of the company.[26]

These customers all have different wants and have five basic needs:[27]

- **Service**. Whenever a customer purchases something, there is an expectation of some service level. It stands to reason that the higher the value of the item or the complexity of the purchase, the higher the expected level of service will be. A customer buying a new car will expect a fairly high level of service compared to a person buying a drill bit for a portrait that has to be fixed.
- **Price**. As customers' disposable income is eroded by higher fuel and electricity prices, and other reasons, the prices that companies charge are becoming more

important to customers. People have to be more selective in their choices, and will look at their overall best value.

- **Quality**. This aspect links closely with the prices charged. Customers are looking for the best quality at a price they can afford; it is the responsibility of the business to be able to meet these expectations.
- **Action**. Customers all over expect quick action when they have a problem or query. Most disgruntled customers come from the inability of businesses to react quickly enough to their complaints or requests. Many companies therefore have toll-free numbers or call centres to assist customers.
- **Appreciation**. A basic need of most customers is to know they are appreciated for their business. This appreciation can be via a simple 'have a nice day' or 'please come again', recognition by name (e.g. in a restaurant), or a simple 'thank you'.

13.15.3.2 Internal customers

As mentioned above, many companies see their customers as only those who buy or use their products. They tend to ignore their own staff – the internal customer.

Internal customers can be defined as the people in the company with whom marketers work daily or on a regular basis. These customers are the frontline staff who interact on a daily basis with the external customers of the business – and, by implication, determine the success of the business. They are the ones the external customer uses to judge the company and evaluate whether their expectations are met.

More often than not, we think of customer service as an external activity – something that occurs outside the organisation to keep paying customers happy. However, internal customer service is also very important and cannot be neglected. Serving the people with whom we work and doing everything we can to help them do their job well is critical to the organisation's success.

Servicing internal customers means treating your colleagues as if they were your paying customers. It also implies delivering quality work in a courteous and helpful manner. This may mean that you do something more for your colleagues – more than was expected – and work the extra time or expend that extra energy. Internal customer service is the same as external customer service; it just applies to the people within the company rather than outside it.[28]

The benefits of good internal service are as follows:[29]

- It leads to better teamwork and co-operation in an organisation. The staff feel more at home and comfortable working for the business.
- It can be a great motivator for all to do their best and meet targets in terms of quality, on time and within budget.
- It will have a positive impact on the growth of a company as well as its employees.
- It gives a sense of belonging, satisfaction and fulfilment to employees; they are more engaged with the business and its customers.

Internal customers must see and accept external customers in the following light:[30]

- External customers are the most important people in any business.
- They are not dependent on us – we are dependent on our customers.
- Customers are not an interruption of our work – they are the reason for our work.
- Customers are actually doing us a favour by calling or patronising the business – we are not doing our customers a favour by serving them.
- Customers are part and parcel of our business – they are not outsiders.
- Customers are not figures or statistics – they are flesh-and-blood human beings with feelings and emotions like our own.
- Customers are not people with whom to argue or match wits.

- Customers are people who have specific needs that need to be fulfilled – it is our job to fill those needs.
- Customers are deserving of the most courteous and attentive treatment we can provide.
- Customers are the lifeblood of every business.

The only way to succeed is for all employees to believe that their jobs are not a series of tasks and duties, but rather an integral part of creating value for customers. By ensuring that a common focus exists in the company regarding the keys to success, i.e. customers, other problems can be overcome.

13.15.4 The importance of excellent customer service

It should be clear from the definition of customer service and the importance of internal and external customers that excellent customer service is vital to any organisation. In spite of the accepted importance of customer service the delivery of excellent customer service is rare. In many businesses today, everyone mentions how important customer service is, but very few know how to provide outstanding customer service.[31] Companies that provide excellent customer service experience a number of potential rewards, the most beneficial of which are the following:[32]

- When customers approach a company, they expect to have a positive experience.
- The work of staff is more personally fulfilling.
- In some instances, customers act as co-producers of the product or service, and so assist in the provision of their own customer service.
- Companies gain a unique competitive advantage.
- Companies note the challenges that customers provide and develop solutions to meet these challenges, thereby keeping the customers.
- Companies solve problems creatively in an effective and efficient manner.
- The employees who provide customer service, as well as management, feel more positive about the role they play in the creation of positive exchanges between customers and the organisation.
- Work environments are more pleasant and productive because the value of internal customers is stressed through organisational policies, procedures and culture.
- Businesses build up a more positive reputation in the market and, in the process, earn the respect of customers and peers.
- Organisations accomplish profit goals more successfully because business philosophies and focus are geared to meeting the needs of customers.

The value of good service is seen by Kamin[33] as very important to the survival of a business. According to him, it is a service world out there and the survivalists in future will be those organisations that see customer service as the priority of their total offering. Delivering good service is no longer optional – it is fundamental to the success of an organisation. The importance of good service can no longer be ignored as competition is getting tougher every day.

The fact that the global market has become accessible with the advent of the Internet has also placed pressure on businesses to excel in customer service. Today, for somebody to buy a plane ticket, hotel stay or movie ticket, they need only click a button. Added to this is the fact that there is no threat of bad service – perhaps only bad technology or technical aspects. Having said this, remember that there is always the need for a personal touch when engaging in dealing with businesses.[34] If the business cares for the customer, it will ensure that the customer is satisfied with the whole experience and feels as if the organisation cares.

Service, as indicated above, is important to customers. So, it is also important to the business and its growth. It is not a 'nice to have', but an essential element of the total product offering and customer experience, and a key differentiator for most businesses trying to compete.

Research shows the importance of customer service

The following are findings based on a report compiled by the Forum Corporation based on responses from more than 5 700 customers, employees and managers.[35]

- The likelihood of a customer changing suppliers is five times higher when customers experience real or perceived service problems than it is when customers experience price or product quality issues.
- The aims of the business and the customer are different, which implies that impressions of service quality from the customer's side and what the company is good at may differ.
- Companies who have a stable sales staff generally perform better in terms of quality of service.
- If a customer feels valued and cared for, chances are that he or she will return to the business and even become a loyal customer.
- Companies that take care to solve customers' problems in a satisfactory matter are more likely to make loyal customers.
- The average customer's lifetime with an organisation is approximately ten years if they are satisfied with the service they receive from the company.

13.15.5The place of customer service in the marketing strategy

The marketing strategy of a company traditionally consists of the four Ps, namely product, price, promotion and place (distribution). Customer service must be embedded in all four aspects of the marketing strategy by offering customers the right products at the right price, supported by the right promotion, and made available at the right time and place.

Marketing concepts are developed on the basis that customers are at the centre of all organisational activities. The purpose of an organisation's marketing strategy is to win and retain customers. This applies not only to business organisations, but also to governments and social service organisations. Without this goal, organisations would not be able to achieve their objectives and would not remain relevant.[36]

One of the main focus points of marketing actions is the establishment and maintenance of relationships. This is based on the belief that it costs several times more to find new customers than to retain existing customers. When customers defect to a competitor, the profit-making potential of the company is hampered. It is therefore important that a company retains existing customers and establishes strong long-term relationships with them so that they stay loyal to the company.

In relationship marketing, also called customer relationship management (CRM), every customer is seen as a segment of one. The relationship is built on messages that convey, to each of the customers, recognition, willingness to help, concern and implicit trust, providing great customer service.[37]

The typical mistake that many businesses make is to give good initial service and then to neglect customers and think that they will stay with the company. Some time later, the owners of these business find themselves wondering what happened to their customers and not knowing why they left.

There are many reasons why a customer or client may leave you, but the ones you will hear most often are as follows:[38]

- They felt your pricing was too high or unfair.
- They had an unresolved complaint.
- They took a competitor's offer.
- They felt that you did not care about them.

It is common practice in business to focus primarily on new customers rather than looking after existing customers. It would be wise to look at the following statistics before focusing on new customers alone:[39]

- Repeat customers spend 33 per cent more than new customers.
- Referrals among repeat customers are 107 per cent greater than among non-customers.
- It costs six times more to sell something to a prospect than to sell that same product to an existing customer.

Customers should be seen as part and parcel of the marketing strategy of the company – they are strategic partners. The company must meet their needs by ensuring that customer service is embedded in all four Ps of the marketing strategy. Customers will quickly see if the company is indifferent and they will simply not tolerate bad service and may revert to social media to vent their frustration, thus possibly damaging the brand.

To provide good to exceptional service, a company must do the following:[40]

- **Make a great first impression**. Making an impression on customers requires a few simple things such as a smile, a friendly, open demeanour, keeping eye contact (but not staring), being dressed in line with customer expectations, and looking neat and presentable.
- **Project a positive attitude**. Focusing on a few of life's simple things – such as showing that you are interested, helpful, caring, trustworthy, reassuring and reliable – can go a long way towards projecting a positive attitude. These traits are further enhanced by being respectful, and coming across as confident and open-minded. Customers tend to connect to such a person.
- **Communicate effectively**. You can only respond properly to customers' requests or questions by focusing and listening carefully, waiting for customers to complete their request or question, and showing that you understand their needs. Think before you speak and speak clearly, using proper grammar and facial expressions that convey concern or solutions depending on the situation. Listen more than you speak.
- **Build and maintain relationships**. Build a rapport with customers as these relationships may well last for a long time to come. It is always best to ask a number of questions to ensure that you completely understand the needs of customers and to find the best solutions. Find the right solution for each particular customer. Remember customers' names and faces. Make each customer feel valued.

13.15.6 Managing customer expectations

Customers have certain expectations that must be met when they buy a product. Expectations are a personal vision of the outcome of an experience and may be positive or negative. These expectations are based on a customer's perceptions. If a customer's previous experience with a business was negative, the customer may approach a new situation with the expectation that he or she will again be disappointed.

It is essential for businesses to recognise that customers have different levels of expectations. There are two basic levels. Primary expectations are a customer's most basic requirements for an interaction. For example, when a young woman goes to a

hairdresser, her primary expectations are to get her hair washed, cut, maybe coloured and blow-dried, and to pay a reasonable price. Secondary expectations are based on previous experiences that serve as enhancements of our primary expectations: at the salon, the woman expects the hairdresser to be friendly, and for her hair to be styled in a way that complements her face.

Remember that these expectations are not static, but change all the time. In fact, they can change by the day, or even by the hour, depending on the product or service.

Customers have higher expectations and more choices than ever before. This means that marketers have to listen more closely to customers than ever. They must also anticipate needs, solve problems before they arise, provide service that impresses customers and offer responses to mistakes that more than make up for the original error. Competitors have not only been meeting these rising expectations, but also shaping them with yet higher standards of performance and value. The cycle thus continues, with customers asking for more and receiving it. So, there is no reason why customers should buy one organisation's offerings unless it is, in some way, better at serving customers' needs than competing organisations.[41]

Understanding customers' expectations and perceptions is therefore crucial to the survival of a business, and companies need to manage this. In essence, customer service is about expectations as discussed below.

13.15.6.1 Customer service is all about expectations

When you buy a product such as a computer or a Playstation game from a second-hand store, you expect the quality to be reasonable, but not the best. However, when you buy a computer from Apple, for example, you expect the quality to be excellent. In many instances, these expectations are closely linked to the price that customers pay for the product.

When it comes to service, expectations can become a little fuzzy. When customers begin a relationship with a company, they already have a specific set of expectations. These expectations are based on their perceptions of you, your company and your industry. They are formed through past personal experience and the experience of other people with whom customers interact.[42]

When it comes to service specifically, studies by Len Barry have shown what is important to customers. He uncovered five primary dimensions to service that affect customers' perception of the service they have received. These are:[43]

- **Reliability**. Customers want services to be performed well and when the company says they will perform them.
- **Responsiveness**. Customers want their needs met with speed and initiative. This also means that they want their queries answered.
- **Assurance**. Customers want service providers to be knowledgeable, courteous and trustworthy.
- **Empathy**. Customers want care and concern, and desire to be treated as individuals.
- **Tangibles**. Customers care about the tangible product, or the service, and the physical appearance of the facilities and people.

13.15.6.2 The consequences of bad customer service[45]

In the prevailing business climate worldwide, it is easy to lose a customer – and even easier if bad service is given. When a business neglects its customers' concerns, treats them disrespectfully and fails to deliver on promises, customers will leave that business for another. When customers leave a business, there are the following consequences:

- The business loses the income that the relationship generated. The loss of one client may seem insignificant, but over time the effects can be damaging.
- The reputation of the business may suffer as customers will share their negative experiences with friends and family.
- There is a loss of future business.
- There are high levels of complaints.
- Employees become unhappy due to a bad atmosphere in the business.

The company needs to be aware of the fact that there is a cost associated with bad service.

The impact of bad customer service[44]

The research firm TARP has conducted various studies to determine the impact of bad customer service. The research revealed the following:

- It will cost an organisation at least five times more to acquire a new customer than it will to keep an existing one.
- At least 50 per cent of customers who experience problems will not complain or contact the organisation for help – they will simply go elsewhere.
- Customers who are dissatisfied will tell as many as 16 friends about a negative experience with an organisation.
- The average business loses 10 to 15 per cent of its customers per year because of bad service.

The loss of a customer and the sale must not be looked at in isolation as there is a cumulative cost involved. This cost is much more than the cost of one lost sale. Remember that if a customer leaves and decides not to return, future sales (or potential sales) are also lost. Consider, for example, a young man who takes his car for a wash and polish at the carwash four times a month and pays R120,00 per wash. This means he is responsible for R480,00 worth of sales each month. After one wash, the young man complained that his car had not been cleaned properly. The manager just ignored him, resulting in the young man taking his business somewhere else. The net effect over a five-year period will be:

R480 per month × 12 months × 5 years = R28 800,00 over this period.

Add to this the number of people that the customer will tell and dissuade from going to this carwash, and the figure becomes much higher. It is therefore imperative that companies manage customers' experiences to ensure that bad service does not lead to a loss of revenue.

Sources: Machado, R. (Ed). 2014. *Customer service*. Second edition. Cape Town: Juta, p. 17; Peterson, T. 2013. Customer loyalty. Available at http://prezi.com/odxh6shkrwa3/customer-loyalty/ [Accessed 13 May 2019].

13.16 Summary

This chapter focused on the elements of the marketing process. Aspects covered include the definition of marketing, the gradual change in management's approach to marketing, the marketing concept, market research, market segmentation and target-market selection, consumer behaviour and the four marketing instruments.

It was shown that a market-driven organisation is essentially consumer oriented, makes strategic decisions based on pertinent information and maintains close relationships with a view to long-term profitability.

Marketing is a key function of an organisation, as was shown in the sections that dealt with the four marketing instruments that are combined in a marketing strategy. Opportunities in the environment must be met and threats must be dealt with within the framework of an ethical code of conduct, the marketing concept.

The various product decisions (including the product range, the brand, the packaging, the method used to differentiate the product from other products and new product development) were discussed. Product decisions consist of decisions regarding price, distribution and marketing communication or promotion. Distribution decisions entail considering the various distribution channels and the market coverage. It has been shown that a channel captain is able to dominate an entire channel and that large retailers, rather than producers, can act as channel captains. Price decisions are important because a price that is too low may lead to financial loss, perhaps giving the impression that the product is of inferior quality. Prices should be determined in such a way that they stimulate a demand for products. The marketer communicates with consumers through advertising, personal selling, direct marketing, sales promotion and publicity, endeavouring to inform them and persuade them to buy a specific brand repeatedly. Large sums of money are spent on producing effective messages to reach consumers. Public relations is a tool that can be used to support and maintain the positive image of an organisation with its many publics.

To conclude, marketing is a paradox. While it is a simple process, it can, at the same time, be extremely complex. It is at once a philosophy and a dynamic function of a business. It is new, but it is also as old as humankind itself.

Small business persepctive

While this chapter covered a broad spectrum of activities, these activities apply to both small and big organisations, albeit in different ways. Let's look at the case of a small business – for example, a boutique. Before deciding to open the boutique, some market research is required to establish whether there is a need for it, the type of styles that should be offered and even the level of exclusivity. Furthermore, the level and type of competition in the market must be researched. Based on this feedback, market segmentation will be done on the range of criteria such as age, sex, lifestyle, geographical area, etc. The small business owner must decide to focus on one segment or on the total market. He or she may decide to target women who live in the more exclusive suburbs in Cape Town, in the 35+ age group, who are socially active and who are looking for an exclusive once-off item. This will imply certain behaviour, which must be analysed based on consumer behavioural trends. If the small business owner knows who his or her customers will be and how they buy, he or she can make final decisions about the product range, the prices to charge, where to locate the shop and how to communicate with his or her potential customers.

This process is continuous. Once the boutique is up and running, the owner needs to keep monitoring the situation to detect any changes, and to adapt the boutique's offering as required.

KEY TERMS	
advertising	marketing components
bait prices	marketing mix
brand	marketing orientation
brand decisions	marketing process
brand insistence	marketing strategy

brand loyalty	marketing thought
brand name	new product decisions
brand preference	odd prices
brand recognition	opinion leaders
buyer	packaging
channel	personal selling
channel captain	physical distribution
consumer behaviour	product
consumer orientation	product decisions
consumer products	product differentiation
cost price	product diversification
coverage	product items
demographics	product lines
distribution	product obsolescence
distribution channels	product offering
evaluating	product orientation
exclusive market	product ranges
family packaging	product-range extensions
fieldworkers	product recall
final price	profit
generic brands	psychographic
geographic	publicity
group factors	questionnaires
individual factors	reference group

individual/family brands	relationship marketing
intensive market	research methodology
leader prices	retailer
leadership price	reusable packaging
manage	sales forecasting
manufacturer	sales orientation
market coverage	sales promotion
market forecasting	segment
market positioning	segment profile
market price	selective market coverage
market research	seller
market segment	services
market-penetration prices	skimming prices
market-price level	speciality packaging
marketing	target price
marketing communication	wholesalers

Questions for discussion

1.What is meant by customer service and why is good customer service important in an organisation?
2.What can organisations do to create superior customer service for their customers?
3.What is the role of customer service in the marketing strategy?
4.Why should a business consider customers' perceptions and expectations?
5.What are the consequences that a business will face if bad customer service is provided?

Multiple-choice questions

1.Segmenting a population according to its annual income, occupation and lifestyle would fall under which type(s) of consumer segmentation base(s)?

a.Geographic, demographic, psychographic and behavioural segmentation.
b.Geographic, demographic and psychographic segmentation.
c.Demographic and psychographic segmentation.
d.Behavioural segmentation.

2.When the initial price of a new product is lower and the marketer hopes to penetrate the market rapidly by discouraging competitors in the process, this is known as ________.

a.skimming prices
b.leader pricing
c.bait pricing
d.market-penetration pricing

3.Which of the following is not associated with the four variables (the four Ps) used for decision-making?

a.The product itself
b.The place where it is made
c.The marketing communication methods used to inform consumers about the product
d.The price, which reflects the product's value to consumers.

4.Which of the following combinations are the basic needs of customers?

i.service, price, quality, action
ii.price, service, quality
iii.service, price, quality, action, appreciation
iv.price, quality, appreciation, action
a.i
b.ii
c.iii
d.iv

5.A long-term relationship with the customer is one of the benefits of ______ .

a.sales promotion
b.direct marketing
c.publicity
d.advertising

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CHAPTER 14

Financial management

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The purpose of this chapter

This chapter explains what financial management entails and illustrates financial decisionmaking.

Learning outcomes

On completion of this chapter you should be able to:

- describe and apply the fundamental principles of financial management
- determine the break-even point of a business organisation
- calculate the present and future value of amounts
- analyse and interpret the financial statements of a business organisation
- understand the financial planning process
- manage the current assets of a business
- evaluate investment decisions
- find financing for a business.

14.1 Introduction

Financial management is the art and science of obtaining enough finance for a business at the lowest cost, investing in assets earning a return greater than the cost of capital, and managing the profitability, liquidity and solvency of the business. In financial management, we start by answering the following questions:

- Which long-term investments should we take on as a business? That is, which lines of business should we be in and what sorts of buildings, machinery and equipment do we need?
- Where will we get the long-term financing to pay for these investments? This could mean bringing in other owners or borrowing the money needed.
- How will we manage the everyday financial activities such as collecting from customers and paying suppliers?

In other words, the financial management decisions will be around the following:

1. Capital budgeting: That is, the business's long-term investment, the process of planning and managing a business's long-term investments, so called capital budgeting, and which investment opportunities exist for the business. It should be noted that the size, timing and risk of future cash flows are the most important questions to be answered under this part of financial management.
2. Capital structure: That is, the ways in which the business obtains and manages the long-term financing it needs to support its long-term investments. This includes the mixture of debt and equity that a business uses to finance its operations. Questions involve where and how to get the financing, and the expenses associated with raising long-term financing. Choosing lenders and different types of debt financing are among the most important issues to be addressed. The financial manager needs to ask and ponder the following issues: internal financing, that is,

reinvesting in the business's internal projects; debt (bonds), which have a fixed claim regardless of the business's performance; equity (shares), which has a residual or ownership claim and may receive cash flows left over after debt has been paid; and hybrid securities, such as preference shares, convertible debt, etc.

3.Working capital management: This is related to the short-term assets of the business, such as inventory, and short-term liabilities, such as money owed to suppliers. Questions that should be addressed here are how much cash and inventory a business should keep in hand, and whether it should sell on credit and, if so, under which terms, how a business can obtain short-term financing, purchase on credit or borrow in the short term and pay cash, identify sources of funding short-term expenses, and so on.

4.Finally, financial managers need to worry about how to return the proceeds from the business's investments to shareholders. Questions are related to: (a) paying dividends (note that this increases the need for external capital) and (b) retaining earnings to invest in new projects. This demonstrates to shareholders that the company cares for its welfare and maximises the market value of the business.

In the introductory chapters of this book, the financial function was identified as one of the functional management areas in a business. In this chapter, the nature and meaning of the financial function and its management – in other words, financial management – will be explained. Thereafter, the relationship between financial management, the other functional management areas, related subject disciplines and the environment will be shown. An introduction to a few basic concepts and techniques used by financial management will then follow. The goal and fundamental principles of financial management, including financial analysis, planning and control, will be explained. The chapter also explains how to finance a business and how to evaluate investment decisions.

14.2The financial function and financial management

A business must have the necessary assets such as land, buildings, machinery, vehicles, equipment, raw materials and trade inventories at its disposal if it is to function efficiently. In addition, business organisations need further resources (such as management acumen and labour) and services (such as a power supply and communication facilities).

A business needs funds, also called **capital**, to obtain the required assets, resources and services. The people or institutions (including the owners) who make funds available to the business lose the right to use those funds in the short or long term, and they also run the risk of losing those funds, or a portion thereof, should the business fail. As a result, suppliers of funds expect compensation for the funds they make available to the business (and also a repayment of funds lent to the business) when it starts to generate funds through the sale of the products or services it produces. Hence, there is a continual flow of funds to and from the business. (See Figure 14.13 on page 533.)

The **financial function** is concerned with this flow of funds. In particular, it is concerned with the acquisition of funds (known as **financing)**, the application of funds for the acquisition of assets (known as **investment)**, and the administration of and reporting on financial matters (known as **accounting).**

Financial management is responsible for the efficient management of all facets of the financial function. Within the broad framework of the strategies and plans of the

business, its aim is to make the highest possible contribution to the objectives through the performance of the following tasks:

- Financial analysis, reporting, planning and control;
- Management of the application of funds, also known as the management of the asset structure; and
- Management of the acquisition of funds, also known as the management of the financing or capital structure.

Financial management cannot function in isolation. Besides the interdependence between the functional management areas (without production and marketing, for example, no funds will be generated, and vice versa), financial management should also depend on other related subject disciplines, such as accounting and economics, if it wants to be efficient. As a subsystem of the business, the financial function, and therefore its management, is also influenced by environmental factors. The relationship between financial management, the other functional management areas, related subject disciplines and the environment is illustrated in Figure 14.1.

The case study that follows provides an illustration of how financial management is applied in a real-life situation.

Figure 14.1: The relationship between financial management, other functional management areas, related disciplines and the environment

CASE STUDY: Financial management in action

Imagine that you own 20 000 shares of a retail firm listed on the JSE. You bought these shares at R5,20 each two years ago, but the price has subsequently declined to R1,90 each. Other firms in the same sector have seen increases in their profitability and share prices.

The annual general meeting (AGM) is scheduled to take place in six weeks' time.

From the firm's financial statements, you have determined the information shown in Table 14.1.

Table 14.1: Information determined from the firm's financial statements

Ratio	This year	Average of the previous five years
Gross profit margin	40%	55%
Net profit margin	15%	30%
Return on assets	10%	21%
Return on equity	9%	24%
Earnings per share	45 cents	480 cents
Debt ratio	2%	10%
Current ratio	2,6:1	2:1
Quick ratio	0,8:1	1:1

The economic outlook is positive, interest rates are expected to decline, consumer spending is on the increase and inflation is below 3 per cent. However, the top management seems to be divided about the issues facing the firm.

1. What can management do to improve the firm's profitability?
2. What can the investors (shareholders) do to improve matters?

Answers

1. The actions management could consider for improving the firm's profitability are summarised in Table 14.2.
2. An ordinary shareholder of a public company is entitled to vote at the annual general meeting of the company. The shareholder can improve matters by attending the AGM, and by nominating and voting for new members of the board of directors. If the shareholder cannot attend the meeting himself or herself, he or she can complete a proxy form and nominate someone who will be attending the meeting to vote in a particular manner on his or her behalf. Selling your shares will cause a loss of at least R3,30 per share or a total of R66 000 (R3,30 × 20 000 shares) before any transaction costs are taken into account. It might be worth engaging management and exerting pressure to implement a turnaround strategy that includes the actions described in Table 14.2.

Table 14.2: Actions management could consider for improving a firm's profitability

Ratio	Suggestions
Gross profit margin	1. Increase sales by means of more effective marketing and/or by relaxing the credit stand (increasing credit sales).
	2. Reduce the cost of products sold by buying products at a lower cost from another supp stocking products with a faster turnover rate and/or reconsidering products with slow turn
Net profit margin	1. Increase sales by means of more effective marketing and/or relaxing the credit standar (increasing credit sales).
	2. Reduce the operating expenses and/or improve productivity by means of, inter alia, per management systems, training and more effective use of technology.
Return on assets	1. Increase sales by means of more effective marketing and/or relaxing the credit standar (increasing credit sales) while decreasing expenses or using existing capacity more effec
	2. Review assets (disinvest non-core business units, use outsourcing and/or improve prod
Return on equity	1. Increase sales by means of more effective marketing, consider relaxing the credit stand (increase credit sales) during periods of positive economic growth and reducing the cost sold. Reduce operating expenses and improve productivity.
	2. Reduce equity (buy back shares and cancel them), borrow to do so (increase the debt r
Earnings per share	1. Improve profitability (as indicated above) by increasing sales and reducing expenses.
	2. Reduce the number of shares (buy back shares and cancel or consolidate shares). Rep financing with debt financing.

14.3 Concepts in financial management

As in any field of study, it is necessary to describe certain concepts in financial management to present the subject in a meaningful manner.

14.3.1 The statement of financial position

The **statement of financial position** allows the viewer to have an overall grasp of the financial position of a business. It may be diagrammatically represented, as in Figure 14.2.

The information in Figure 14.2 is largely self-explanatory. The **asset side** reflects all the possessions of the business, together with their respective values as at the date on which the statement was prepared, and therefore shows the mutual coherence between these possessions. These assets represent the **asset structure** of the business. Assets are normally divided into two broad categories in the statement of financial position:

1. **Non-current assets**, such as land, buildings, machinery, vehicles and other equipment that will be used in a business for more than a year.
2. **Current assets** such as cash in the bank, as well as other possessions of the business that will be converted into cash within one year during the normal course of business, such as marketable securities, debtors and all inventories.

Figure 14.2: A diagrammatic representation of the statement of financial position

The values at which the assets are recorded in the statement of financial position differ according to the objectives for drawing up the statement of financial position. For this reason, it is essential that the statement of financial position should provide an indication of the values at which the assets have been recorded, for example, cost, cost less depreciation or cost plus appreciation.

The **liability** or claims side of the statement of financial position reflects the nature and extent of the interests in the assets. In other words, it reflects the mutual coherence of the claims of the persons or institutions that provided funds (capital) for the 'purchase' of the assets. Therefore, the liability side of the statement of financial position shows the **financing** or **capital structure** of the business as at the statement of financial position date.

The liability side of the statement of financial position is usually subdivided on the basis of the following two criteria:

1. The term for which the funds have been made available.
2. The source from which the funds have been obtained.

Therefore, the owners' equity and liability side of a company's statement of financial position will contain the following details:

- **Long-term funds**. This is also known as non-current liabilities and comprises shareholders' interest and long-term debt.
- **Shareholders' interest** is owners' equity (made up of ordinary share capital, reserves, undistributed or retained profits) and, in some instances, preference-share capital. **Long-term debt** is usually made up of debentures, mortgage bonds, secured loans and long-term credit.
- **Short-term funds**. These are also referred to as current liabilities. They represent all debts or credit that are normally repayable within one year. Examples of these

funds are bank overdrafts and trade creditors. The favourable difference between the current assets and the current liabilities represents the net working capital or that portion of the current assets that has been financed from long-term funds.

The shareholders' interest on the liability side of the statement of financial position of businesses that do not have ordinary or preference shareholders (for example, sole proprietorships, partnerships and close corporations) is replaced by a capital account that reflects the owners' interest in the business.

14.3.2 Capital

Capital can be described as the accrued power of disposal over the products and services used by a business to generate a monetary return or profit. Stated differently, the capital of a business may briefly be described as the monetary value of the assets of the business at a specific time.

A business needs capital for investment in fixed assets (referred to as the **need for fixed capital)** and capital for investment in current assets (referred to as the **need for working capital).**

A business has a permanent need for a certain minimum portion of working capital. The remaining need for working capital will vary according to factors such as seasonal influences and contingencies that result in an increase or decrease in production activities.

14.3.3 Income

The **income** of a business consists primarily of receipts resulting from the sale of its products and/or services. The extent of these receipts for a given period will depend on the quantity of products and/or services sold within that period, and the unit price for which they were sold.

Income = Units sold × Price per unit

The income of the business can also be obtained from other sources, such as interest earned on investments. However, this income will not be taken into account in the discussions that follow.

14.3.4 Costs

Costs can be regarded as the monetary value sacrificed in the production of products and/ or services produced for the purpose of resale.

Costs are further subdivided according to certain criteria; hence the business has direct costs, indirect costs, overhead expenses, fixed costs and variable costs.

The subdivision of total costs into fixed and variable costs is of particular importance for decision-making purposes. Thus, the remainder of this section will be devoted to this aspect. A further subdivision will be introduced in the discussion of the statement of financial performance in Section 14.3.6.

Fixed cost is that portion of total cost that remains unchanged (within the boundaries of a fixed production capacity) regardless of an increase or decrease in the quantity of products and/or services produced.

By way of illustration, consider a bakery who is able to bake 1 800 loaves of bread every day. However demand increased and the bakery will have to buy one more oven at R200 000. The firm will borrow money from the bank in order to finance the oven. In this way, a new production capacity is created, which gives rise to a new fixed-cost component.

Total fixed costs as part of total costs for a particular period and capacity can be represented graphically as in Figure 14.3.

Example: Costs

In a manufacturing firm, cost will consist of used material, rent for premises and a building, depreciation of equipment, wages and salaries for all employees, payment for electricity and communication services, and so on.

Figure 14.3: A graphical representation of total fixed costs

Total fixed costs are constant, irrespective of the volume produced. Therefore, the fixed costs per unit produced will decrease with an increase in the quantity produced, as illustrated in Figure 14.4.

Figure 14.4: A graphical representation of fixed costs per unit

Variable cost is that portion of the total costs that changes according to a change in the volume produced. Some variable cost items, such as manufacturing material costs, can be regarded as pure variable costs because they change in direct proportion to a change in the volume produced. Other variable cost items contain a fixed-cost component, such as the fixed telephone rental. In this instance, there is not a pure linear relationship between these variable cost items and the volume produced. Therefore, these costs are referred to as **semi-variable costs**. Since these semi-variable costs do not have any substantial effect on the principle of fixed and variable costs, a pure linear relationship can, for purposes of illustration, be assumed between total variable costs and volume produced, as represented in Figure 14.5.

Figure 14.5: A graphical representation of total variable costs

The **variable costs per unit** produced remain more or less constant irrespective of the quantity produced. This point is illustrated in Figure 14.6.

Figure 14.6: A graphical representation of variable costs per unit

The **total costs** involved in the production of a specific number of products produced in a particular period consist of the total fixed costs and the total variable costs incurred in the production of those products. Figure 14.7 graphically illustrates how total costs are arrived at.

Figure 14.7: A graphical representation of total costs

To summarise, it may be stated that the total costs of the business comprise a fixed and a variable component, each of which has a specific relationship with the volume of production. These relationships have a specific influence on the profit made by businesses, as discussed in Section 14.5.

14.3.5 Profit

Profit is regarded as the favourable difference between the income earned during a specific period and the **cost** incurred to earn that income. A **loss** results when the cost exceeds the income.

Profit or loss = Income – Cost

or

Profit or loss = (Price × Units sold) – Cost

Although the above comparison applies in general, various profit concepts in the different stages of the profit-determining process may be identified in the statement of financial performance.

14.3.6 The statement of financial performance

The statement of financial performance, one of the annual financial statements of a business, furnishes details about the manner in which the profit or loss for a particular period was arrived at and how it has been distributed.

Figure 14.8 represents, in diagrammatic form, the statement of financial performance of a manufacturing business in company form. A numerical example of a statement of financial performance of such a business appears in Section 14.7.1.1, while certain profit concepts are also further highlighted in Figure 14.8. Note that the statement of financial performance of a sole proprietorship, a partnership and a close corporation will, in essence, differ solely in the division of the net profit.

The information in Figure 14.8 is largely self-explanatory.

*Appears in the liability side of the statement of financial position – see section 14.3.1

Figure 14.8: A diagrammatic representation of the statement of financial performance

Note that accountants sometimes use certain terms associated with statements of financial performance interchangeably, for example:

- sales/turnover
- operating profit/earnings before interest and tax (EBIT)
- profit/earnings; and
- net profit/earnings after tax/net income.

14.4 Objective and fundamental principles of financial management[1]

The long-term objective should be to increase the value of the business. This may be accomplished by:

- investing in assets that will add value to the business; and

- keeping the cost of capital of the business as low as possible.

The short-term financial objective should be to ensure the profitability, liquidity and solvency of the business. Profitability is the ability of the business to generate income that will exceed cost. In order to maximise profit, a firm has to maximise revenue from sales while limiting expenses to the essential.

Liquidity is the ability of the business to satisfy its short-term obligations as they become due. In other words, it is the business's ability to pay the trade creditors by the due dates. Liquidity can be improved by accelerating cash inflows (collecting accounts receivable as fast as possible or making cash sales only) and paying creditors as late as possible.

Solvency is the extent to which the assets of the business exceed its liabilities. Solvency differs from liquidity in that liquidity pertains to the settlement of short-term liabilities, while solvency pertains to long-term liabilities such as debentures and mortgage loans.

Financial management is based on three principles: the risk–return principle, the cost–benefit principle and the time value of money principle.

14.4.1 The risk–return principle

Risk is the probability that the actual result of a decision may deviate from the planned end result, with an associated financial loss or waste of funds. Risk differs from uncertainty in that in the case of the latter, there is no probability or measure of the chances that an event will take place, whereas risk is measurable by means of statistical techniques.

Similar to the cost–benefit principle, the **risk–return** principle is a trade-off between risk and return. The greater the risk, the greater the required rate of return will be.

14.4.2 The cost–benefit principle

Decision-making, which is based on the cost of resources only, will not necessarily lead to the most economic utilisation of resources. Sound financial decision-making requires making an analysis of the total cost and the total benefits, and ensuring that the benefits always exceed the cost. One application of the cost–benefit principle is illustrated in Section 14.5 when the cost–volume–profit relationship is explained.

14.4.3 The time value of money principle

The **time value of money** principle means a person could increase the value of any amount of money by earning interest. If, however, the amount is invested in inventory, equipment, vehicles and so on, then the amount cannot earn interest. This ties up with the previous two principles. From a cost–benefit point of view, the investor has to earn a greater return on the investment in inventory, equipment and vehicles than on the best alternative type of investment. Equally, from a risk–return point of view, the return must compensate adequately for any risk incurred. The time value of money principle will be illustrated in Section 14.6.

Applying the concept Decision time

Someone who invests R500 000 in a business sacrifices the opportunity of earning interest on the amount because it could have been invested in a fixed deposit with less risk to earn 10 per cent interest. The business must earn a return greater than 10 per cent in order to increase the wealth of the owner.

14.5 Cost–volume–profit relationships

The concepts of costs, fixed costs, variable costs, income and profits, among other things, were explained in Section 14.3. In essence, the profitability of a business is determined by the unit selling price of its product, the costs (fixed and variable) of the product and the level of the activity of the business (the volume of production and sales). A change in any one of these three components will result in a change in the total profit made by the business. The components therefore have to be viewed in conjunction with one another and not in isolation. The underlying connection can be explained by means of a simplified numerical example in which only the volume of production and sales changes.

The calculation in the example is referred to as a **break-even analysis**, where the breakeven point is reached when total costs are equal to total income. At the break-even point, no profit or loss is realised.

The break-even point in a specific case can be calculated by using the following formula:

N in the formula is the number of units (volume) where no profit or loss is made. The term (SP – V) is referred to as the marginal income or variable profit.

Example: Estimating the profitability

Sales price (SP)	R12 per unit
Variable cost (V)	R8 per unit
Total fixed cost (FC)	R100 00 per annum

Number of units manufactured and sold:
N = 30 000 (case 1)
N = 40 000 (case 2)
Profit = P
From P = income – cost

it follows that P = (N × SP) – [(N × V) + FC]

Where

Where

The break-even analysis can also be done with the aid of a graph, as in Figure 14.9.

The break-even point is reached when the total income and total cost curves intersect – in other words, at a sales and production volume of OY where the total costs and total income equal OX.

In the event of any change in the income as a result of a change in the selling price or a change in variable costs and/or fixed costs, the slope and point of intersection of the curves will change. The new break-even point is then to be obtained accordingly. The

profit or loss at any sales volume can also be obtained. These values are the vertical differences between the total-cost and the total-income curves.

From the above examples, it is apparent that the production and sales volumes, the unit selling price, and the fixed and variable costs together have an important effect on the profitability of a business. In practice, this type of analysis is carried out especially in the determination of the minimum size at establishment of a business manufacturing and marketing only one product, and also where the feasibility of potential expansion is concerned. A business that provides more than one product will have to make use of a budgeted statement of financial performance in order to determine its break-even point.

Figure 14.9: A graphical representation of a breakeven analysis

Example: Determining the break-even units

14.6 The time value of money

14.6.1 Introduction to the time value of money

Section 14.2 stated that all businesses require capital. As is evident from the following discussion, the payment or remuneration for the use of money or capital is fundamental to the financial structure of any free-market society. It should be kept in mind in the investment and financing decisions of a business that interest has to be paid for the use of capital. Also, funds or capital are normally required and used for either shorter or longer periods, and the use of capital therefore has a time implication.

Consequently, the purpose of this discussion is to explain the concept of the **time value of money** – the combined effect of both interest and time – in the context of financial decision-making.

Critical thinking

The time value of money influences the way people approach cash flow, as will be illustrated here.

What would you choose if you were faced by the choice of receiving a gift of R10 000 in cash today or the same amount a year from now? Obviously, you would choose to be given the R10 000 today. Why?

- The R10 000 received today can be invested to earn interest, resulting in a larger amount after one year, purely because of the time value of money.
- The person who wishes to donate the money may not be able or willing to donate the money a year from now. To wait causes risk and uncertainty.

•During times of inflation, the real purchasing power of R10 000 will decline as time goes by.

In principle, the time value of money bears a direct relation to the opportunity of earning interest on an investment. This is the opportunity rate of return on an investment. The opportunity to earn interest in the interim period is foregone if an amount is expected at some point in time in the future rather than being received immediately.

The time value of money can be approached from two different perspectives. On the one hand, the calculation of the **future value** of some given present value or amount is possible, as is, on the other hand, the calculation of the **present value** of some expected future amount.

The processes for the calculation of future values **(compounding)** and for the calculation of present values **(discounting)** proceed in opposite directions, as indicated in Figure 14.10.

Figure 14.10: The relationship between present value and future value

14.6.2The future value of a single amount

The future value of an initial investment or principal is determined by means of **compounding**. This means that the amount of interest earned in each successive period is added to the amount of the investment at the end of the preceding period. Interest in the period immediately following is consequently calculated on a larger amount consisting of capital and interest. Interest is therefore earned on capital and interest in each successive period.

The formula for calculating the future value of an original investment is:

$$FV^n = PV\,(1+i)^n$$

Where:

- •PV is the original investment or present value of the investment.
- •FV_n is the future value of the investment after *n* periods.
- •*i* is the interest rate per period expressed as a decimal number.
- •*n* is the number of discrete periods over which the investment extends.

In fact, these symbols also appear on financial calculators.

The factor $(1 + i)^n$ in the formula is known as the **future-value factor** (FVF) or **compound-interest factor** of a single amount.

The process for future-value calculation is illustrated in Figure 14.11.

The future value of an original investment can also be calculated by using tables. An extract from these tables follows.

The example below for a three-year investment at an interest rate of 5 per cent per annum is calculated as follows with the aid of Table 14.3 on page 527:

The result is identical to the one obtained by using the formula.

Bear in mind that the future-value factor $(1 + i)^n$ is an exponential function, which means that the initial amount will grow exponentially over time.

The higher the interest rate, the faster the future value will grow for any given investment period as a result of the compounding effect. Consequently, interest is earned on interest in each successive period. The concept of the compound interest rate as a growth rate is of vital importance in financial management.

The values of any of the four variables in the equation for the calculation of the future value can be determined if the values of the remaining three variables are known.

Example

What is the future value of R100 invested for one year at an interest rate of 5 per cent per annum?

And if the investment term is 3 years?

Figure 14.11: Process for future-value calculation

Table 14.3: Extract from a table used to calculate future value of an original investment

14.6.3 Present value

14.6.3.1 The present value of a single amount

The present value is also based on the principle that the value of money is, among other things, affected by the timing of receipts or disbursements, as in the case of the future value.

If it is accepted that a rand today is worth more than a rand expected at some future date, what would the present value be now of an amount expected in future? The answer to this question revolves around the following:

- Investment opportunities available to the investor or recipient; and
- The future point in time at which the money is expected.

An amount of R105 that is expected one year from now will have a present value of R100, provided the opportunity exists to invest the R100 today (time t_0) at an interest rate of 5 per cent per annum.

The interest rate, which is used for discounting the future value of R105 one year from now to a present value of R100, reflects the time value of money and is the key to the present-value approach. This interest rate or opportunity rate of return is the rate of interest that could be earned on alternative investments with similar risks if the money had been available for investment now.

Stated differently, it is the rate of return that would be foregone by not utilising the investment opportunity. The process of discounting is explained by means of the time line in Figure 14.12.

Figure 14.12: Process for calculating the present value of a single amount

The **discounting process** is the reciprocal of the compounding process.

Consequently, the formula for the calculation of the present value of a future single amount is:

The factor is known as the **present-value factor** or **discounting factor** for a future single amount.

Tables have also been compiled for the calculation of present values. An extract from these tables follows.

Example: Calculating present values

What is the present value of R105 expected to be one year from now if the investor's opportunity cost (discount rate) is 5 per cent per annum?

What is the present value of R115,76 invested under the same circumstances and expected in three years' time?

Table 14.4: Extract from a table used to calculate present values

In the example on this page, the present value of R115,76 expected three years from now is calculated as follows, with the aid of Table 14.4, at an opportunity rate of return or discounting rate of 5 per cent.

The present value of a single amount is, accordingly, defined as follows:

The **present value (PV)** is the amount that can be invested today at a given interest rate *i* per period in order to grow to the same future amount after *n* periods.

As illustrated in the example on page 528, as long as the opportunity for investment at 5 per cent per annum exists, the investor should be indifferent to a choice between R100 today or R115,76 in three years' time.

Closer investigation of the preceding discounting factors reveals that the values of these factors decrease progressively as *i* or *n*, or both, increase. The exceptionally high decrease in the discounting factor with relatively high interest rates and long time periods means the following:

- The higher the interest rate is, the smaller the present value of a given future amount will be.
- The further in the future an amount is expected, the smaller its present value at a given interest rate will be.

Interestingly, the present-value factor $PVF_{10,10}$ = 0,3855 implies that the present value of R1,00 expected in ten years is only 38,55 cents today, if the R1,00 could have been

invested today at 10 per cent for ten years. If an investment opportunity at 15 per cent should exist (which is not unrealistic), the present value of R1,00 expected ten years from now is only 24,72 cents ($PVF_{15,10}$ = 0,2472). Put differently, this also means that the value or purchasing power of R1,00 will decline to 24,72 cents over the next ten years if the average annual inflation rate is to be 15 per cent a year over this period.

The present-value factors and the future-value factors (as well as the tables for these factors) are based on the assumption that any funds generated in any period over the total duration of the investment or project (such as annual interest receipts) are reinvested at the same interest rate for the remainder of the total investment period.

The values of any one of the four variables in the equation for the calculation of the future value can be determined provided that the values of the three remaining variables are known.

Example

14.6.3.2 The present value of an uneven cash-flow stream

The determination of the present value of a series of unequal cash-flow amounts is approached in the same way as one would approach a single amount, irrespective of the total duration or the number of time periods involved. As in all applications of the time value of money, the timing of the cash receipts or disbursements is of crucial importance. This is evident from the following example of the calculation of the present value of an uneven cash-flow stream at an interest rate or discounting rate of 10 per cent.

The appropriate discounting factors are found in Table 14.4.

This brief overview of the present-value approach is deemed sufficient for the purposes of this discussion. However, in practice, interest on savings accounts and deposits are often calculated biannually, quarterly, monthly, weekly and even daily. This could apply to both future-value and present-value applications, and is known as intra-year compounding and discounting.

14.6.4 Concluding remarks

The principles and application of compounding and the time value of money as a basis for the determination of present values as well as future values have been explained in this section. The present-value approach is an indispensable aid in financial management, particularly for a large business and listed company, where the majority of investment and financing decisions are taken in accordance with the goal of the maximisation of the value of the business. Even for small business organisations, a basic knowledge of compound-interest methodology and unsophisticated discounted cash-flow applications could be invaluable for capital investment decisions.

The most important implications of time value of money are as follows:

- Inflow must be accelerated. (Encourage debtors to pay their accounts as soon as possible.)
- Outflow should be delayed without damaging the firm’s credit record. (Pay creditors as late as possible.)

- Manage inventory as optimally as possible because it represents capital that does not earn a return before it is sold.

14.7 Financial analysis, planning and control[2]

In Section 14.2, effective financial analysis, planning and control were identified as tasks of financial management. In this section, a short review of these related tasks is given.

14.7.1 Financial analysis

Financial analysis is necessary to monitor the general financial position of a business and, in the process, to limit the risk of financial failure of the business as far as possible. Financial analyses will reveal certain trends, as well as the financial strengths and weaknesses of the business so that corrective measures, if necessary, can be taken in time. To help it with its financial analyses, financial management have the following important aids at their disposal:

- The statement of financial performance;
- The statement of financial position; and
- Financial ratios.

The sections that follow will focus on the various statements and the calculation of certain financial ratios.

14.7.1.1 The statement of financial performance

The statement of financial performance has already been described in Section 14.3.6 and diagrammatically represented in Figure 14.8. Consequently, a numerical example of a manufacturing company's abridged statement of financial performance (see Table 14.5) will suffice for the purposes of this section.

14.7.1.2 The statement of financial position

The statement of financial position of a company and the most important statement of financial position items have already been discussed in Section 14.3.1 and represented diagrammatically in Figure 14.2. Thus, a numerical example of a company's statement of financial position will suffice for the purposes of this section (see Table 14.6).

Table 14.5: An example of an abridged statement of financial performance (rand values)

14.7.1.3 The flow of funds in a business

A business has to make optimum use of its limited funds to achieve its objectives. It is therefore necessary to conduct an analysis of how the capital of the business is employed and supplied. This analysis involves the flow of funds in the business.

The flow of funds of a firm is a continuous process and, following on from the previous explanations of the statement of financial position and statement of financial performance, can be represented as in Figure 14.13.

The following points are apparent from

Table 14.6: An example of a company statement of financial position

Figure 14.13:

- The business obtains funds in the financial market and utilises these funds at a cost to produce products and/or services.
- The business sells these products and/ or services at a price higher than the production costs and therefore shows an operating profit.
- Interest is paid to the suppliers of loan capital from the operating profit. This means an outflow of funds from the business.
- The profit remaining after the interest has been paid is taxable. This means a further outflow of funds from the business.
- The profit remaining after tax can be applied to preference and ordinary shareholders' dividends (outflow of funds), reserves and undistributed profits, resulting in a reinvestment in the production process.

It is clear from Figure 14.13 that there is a continuous flow of funds to and from the business.

If the sales value of the products and/or services produced by the business exceeds the costs incurred in the production of those products and/or services, including the depreciation on equipment, the business will show a profit. A portion of the profit, after payment of interest and tax, is normally distributed among the preference and ordinary shareholders in the form of dividends. The remaining profit is reinvested in the business. The reinvestment leads to an increase in the available funds of the business.

Figure 14.13: A simplified diagrammatical representation of the flow of funds of a business

14.7.1.4 Financial ratios

As mentioned earlier, financial ratios are one of the aids that financial management can employ in the process of effective financial analysis and control.

A financial ratio gives the relationship between two items (or groups of items) in the financial statements (especially the statement of financial performance and the statement of financial position). It also serves as a performance criterion to point out potential strengths and weaknesses of the business.

However, it must be emphasised that financial ratios do not identify the reasons for the strengths and weaknesses. They only indicate symptoms that need to be further diagnosed by financial management.

The financial ratios of a business are used by the following interested parties:

- **Financial management**, with a view to internal control, planning and decision-making;
- The **suppliers of borrowed capital**, to evaluate the ability of the business to pay its debt and interest;
- **Investment analysts**, to evaluate the business as an investment opportunity; and
- **Labour unions**, with a view to salary negotiations.

Financial ratios as such have little, if any, usage value, and must be viewed against certain significant standards or norms to give them usage value. Three types of comparisons are significant in this regard:

1. A comparison of the current financial ratios of the business with the corresponding ratios of the past and/ or expected future ratios with a view to revealing a tendency.

2.A comparison of the financial ratios of the business with those of other similar businesses.

3.A comparison of the financial ratios of the business with the norms for the particular industry as a whole.

There are many different kinds of financial ratios and various classification methods. In this section, only a few kinds are mentioned without paying attention to their respective merits. The calculations of the various ratios are explained by using the information given in the previous statement of financial performance (see Table 14.5 on page 531) and statement of financial position (see Table 14.6 on page 532).

LIQUIDITY RATIOS

Liquidity ratios provide an indication of the ability of a business to meet its short-term obligations as they become due without curtailing or ceasing its normal activities. Providers of loan capital are interested in liquidity ratios because they give an indication of the degree to which a business can meet its debt obligations fully and punctually in the normal course of events.

Two liquidity ratios are of importance: the current ratio and the acid-test ratio.

THE CURRENT RATIO

The **current ratio** reflects the relationship between the value of the current assets and the extent of the current liabilities of a business.

Using the figures of ABC Limited contained in Table 14.6 on page 532 results in a current ratio of 2,2:1, calculated as follows:

This means that the business had R2,20 of current assets available for each R1 of its current liabilities (short-term obligations). The smaller the ratio is, the greater the possibility that the business will not be able to meet its debt obligations fully and punctually without curtailing or ceasing its normal activities. Traditionally, a current ratio of 2:1 is recommended.

THE ACID-TEST RATIO

Since inventory cannot always be readily converted into cash in the short term, it may be misleading to evaluate the liquidity position of a business simply on the basis of the current ratio. The **acid-test ratio** should therefore be used in combination with the current ratio as a criterion for evaluating liquidity.

Using the figures of ABC Limited contained in Table 14.6 on page 532 results in an acid-test ratio of 1,4:1, calculated as follows:

This shows that for each rand's worth of current liabilities, the business had R1,40 of current assets, excluding inventory. As in the case of the current ratio, a larger ratio reflects a healthier liquidity position than a smaller ratio. Normally, a minimum acid-test ratio of 1:1 is recommended.

Liquidity ratios should be evaluated with caution. The **nature** and **condition** of the current assets and the 'correctness' of the **values** at which they were recorded in the statement of financial position can cause the actual liquidity position to differ radically from that which is reflected by the liquidity ratios.

Although it is important for a business to be liquid, it is also possible to be excessively liquid. A current ratio of, for example, 5:1 could be an indication that the firm is carrying too much inventory, selling too much on credit, collecting accounts receivable too slowly and/or has too much cash on hand. An acid-test ratio of, for example, 3:1 could be an indication that the firm is selling too much on credit, collecting accounts receivable too slowly and/or has too much cash on hand. In such a case, funds are not being used optimally, but are confined to unproductive use in current assets. It is therefore important to realise that one should not strive without restriction towards an improvement in the liquidity ratios.

SOLVENCY RATIOS

Solvency ratios indicate the ability of a business to repay its debts from the sale of the assets on cessation of its activities. Capital lenders usually show strong interest in solvency ratios because these indicate the risk level of an investment in the business. Seen from another angle, it gives the business an indication of the extent to which it will have access to additional loan capital and the extent of its risk in its current financing.

There are two particularly important solvency ratios: the debt ratio and the gearing ratio.

THE DEBT RATIO

The **debt ratio** may be calculated using the following equation:

Where total assets = non-current assets + current assets

Using the figures of ABC Limited contained in Table 14.6 on page 532 results in a debt ratio of 37 per cent, calculated as follows:

This means that 37 per cent of the assets were financed by debt (including preference shares if they are callable). A lower percentage reflects a more favourable position than a higher percentage, and a maximum debt ratio of 50 per cent is normally required.

THE GEARING RATIO

The **gearing ratio** may be calculated using the following equation:

Using the figures of ABC Limited contained in Table 14.6 on page 532 results in a gearing ratio of 1,7:1, calculated as follows:

This indicates that for each R1 of debt (including preference shares), the business had R1,70 of owners' equity. A larger ratio once again reflects a more favourable situation than a smaller ratio, and a minimum gearing ratio of 1:1 is normally required.

The following aspects concerning solvency ratios need to be emphasised:
•The solvency ratios illustrate the same situation as seen from different angles. To evaluate the solvency situation of a business, it is therefore necessary to use only one of these ratios.
•Solvency ratios should not simply be accepted at face value. What constitutes a safe ratio for a particular business depends on various factors such as the risks to which it is subject, the nature of the assets and the degree to which creditors will be accommodating in emergency situations.

PROFITABILITY, RATE OF RETURN OR YIELD RATIOS

Firms strive to achieve the greatest possible profitability. They therefore also wish to achieve the greatest profitability ratios. To achieve this, they must maximise their income and limit cost (expenses) to the essential. Sound profitability not only enables the firm to survive financially, but it also enables the firm to obtain financing relatively easier. The share prices of listed companies normally increase in reaction to announcements of good profitability figures.

GROSS PROFIT MARGIN

The **gross profit margin** may be found by:

The gross profit margin indicates how profitable sales have been. The gross profit also gives an indication of the mark-up percentage used by a firm. A firm with a gross profit margin of 50 per cent uses (on average) a mark-up of 100 per cent, as will be illustrated here. Assume sales equal R200 and the cost of products sold equals R100. This yields a gross profit of R100 and a gross profit margin of 50 per cent:

Using the figures of ABC Limited contained in Table 14.5 on page 531 and Table 14.6 on page 532 results in a gross profit margin of 25 per cent:

Firms prefer to achieve the greatest possible gross profit margin. In the case of ABC Ltd, the 25 per cent gross profit margin indicates that the firm uses a mark-up percentage of approximately 33 per cent. In other words, products manufactured or bought at, for example, R100 are sold at R133:

A firm aiming to improve its gross profit margin will have to improve its marketing efforts in order to increase sales whilst simultaneously reducing the cost of products sold. The firm could, for example, reconsider aspects of the marketing instruments (product, price, promotion and distribution) and make suitable adjustments, which would in turn require adjustments to the manufacturing process (if it is a manufacturing firm) and/ or procurement. Firms intent on reducing cost should, however, do so with care in order not to sacrifice quality and alienate clients in the process. In this respect, firms normally prefer to improve product features (including quality) in order to justify a price increase.

NET PROFIT MARGIN

The **net profit margin** gives an indication of the overall profitability of the firm and management's ability to control revenue and expenses.

Net profit margin may be found by:

Using the figures of ABC Limited contained in Table 14.5 on page 531 and Table 14.6 on page 532 results in a net profit margin of 7,57%:

In order to improve profitability, management needs to consider the measures already suggested for improving the gross profit margin and focus on operating expenses. Productivity will have to be evaluated and, if necessary, will have to be improved. Firms could calculate annually or quarterly the percentage of sales each operating expense (for example, salaries) constitutes. Management can compare these figures with those of previous years in order to identify deviations.

RETURN ON INVESTMENT (ROI)

This ratio may be computed as follows:

Using the figures of ABC Limited contained in Table 14.5 on page 531 and Table 14.6 on page 532 results in a return on investment (after tax) of 16,8 per cent, calculated as follows:

Return on investment

A firm wishing to improve its return on investment needs to consider the same measures as those proposed in respect of the gross profit margin and net profit margin. Since the total capital (capital employed) is equal to the total assets (employment of capital), the firm needs to investigate whether it could function with less capital and/or improve the productivity (if possible) of its assets. A firm can reduce its capital by paying off long-term loans more quickly (especially during periods of rising interest rates), by paying greater dividends (if the profitability and cash flow permit it), or a portion of the firm's shares could be repurchased and cancelled. The firm also needs to review its core business. Parts of the firm that cannot be regarded as core business can be sold (for example, company houses that are let to employees).

RETURN ON OWNERS' EQUITY (ROE)

The **return on owners' equity** may be calculated using the following equation:

Using the figures of ABC Limited contained in Table 14.5 on page 531 and Table 14.6 on page 532 results in a return on owners' equity of 26,7 per cent, calculated as follows:

An increase in ROE can be achieved by means of an increase in the net profit margin, asset turnover and financial leverage. Financial leverage can be attained by using more

long-term borrowed funds and less ordinary-share capital. A firm could, for example, borrow money in order to buy back its own ordinary shares and cancel the shares that have been bought back. Such an approach can be applied relatively safely during periods of declining interest rates, but is risky during periods of rising interest rates.

So far, liquidity, solvency and profitability ratios have been described. As described earlier, normally an increase in profitability of a listed company leads to an increase in the share price of such a firm. Since the long-term goal of the firm is to increase the value of the firm, management should focus on earning the highest possible return and keeping the cost of capital as low as possible.

14.7.1.5 Concluding remarks

The preceding explanation offered a brief survey of the financial- analysis task of financial management. From the explanation, it is apparent that the statement of financial performance, statement of financial position and financial ratios are important aids in the performance of this task.

In the section that follows, the focus is on financial planning and control.

14.7.2 Financial planning and control

Financial planning forms an integral part of the strategic planning of a firm. Top management has to formulate the vision and mission for the firm, analyse the strengths and weaknesses of the firm, and identify opportunities and threats in the external environment. The probability of successfully implementing the strategy that top management has decided on depends on the extent to which the firm has suitable human and financial resources at its disposal, or can attract such resources.

Financial planning and control are done in most business organisations by means of budgets.

A budget can be seen as a formal written plan of future action, expressed in monetary terms and sometimes also in physical terms, to implement the strategy of the business and to achieve the goals with limited resources. As such, budgets are also used for control purposes. Control is done by comparing the actual results with the planned (budgeted) results periodically or on a continuous basis. In this way, deviations are identified, and corrective action can be taken in time.

This section provides a brief overview of the following issues:

- The focal points of budgets in the control system of a manufacturing business.
- An integrated budgeting system for a manufacturing business.
- Zero-base budgeting.

Critical thinking

The link between profitability and share prices

Will the share price of a company (listed on a securities exchange) increase if the firm’s profitability increases?

Normally, yes. Keep in mind, however, that a good company is not necessarily a good investment. The reason for this is that those who have superior information anticipate the improved profitability of the firm better than the uninformed investor. Once the information about improved profitability is announced in the media, the share price would already reflect such information. An investor buying these shares at that point in time would be buying a fully priced or overpriced share and will not necessarily achieve a high rate of return from the investment.

14.7.2.1 The focal points of budgets in a control system

Control systems are devised to ensure that a specified strategic business function or activity (for example, manufacturing or sales) is carried out properly. Consequently, control systems should focus on, and budgets should be devised for, various responsibility centres in a business. A responsibility centre can be described as any organisational or functional unit in a business that is headed by a manager responsible for the activities of that unit. All responsibility centres use resources (inputs or costs) to produce something (outputs or income). Typically, responsibility is assigned to income, cost (expense), profit and/or investment centres:

- In the case of an **income centre**, outputs are measured in monetary terms, though the size of these outputs is not directly compared with the input costs. The sales department of a business is an example of such an income centre. The effectiveness of the centre is not measured in terms of how much the income (units sold × selling prices) exceeds the cost of the centre (for example, salaries and rent). Instead, budgets in the form of sales quotas are prepared and the budgeted figures are compared with actual sales. This provides a useful picture of the effectiveness of individual sales personnel or of the centre itself.
- In the case of a **cost centre**, inputs are measured in monetary terms, though outputs are not. The reason for this is that the primary purpose of such a centre is not the generation of income. Good examples of cost centres are the maintenance, research and administrative departments of a business. Consequently, budgets should be developed only for the input portion of these centres' operations.
- In the case of a **profit centre**, performance is measured by the monetary difference between income (outputs) and costs (inputs). A profit centre is created whenever an organisational unit is given the responsibility of earning a profit. In this case, budgets should be developed in such a way that provision is made for the planning and control of inputs and outputs.
- In the case of an **investment centre**, the monetary value of inputs and outputs is again measured, but the profit is also assessed in terms of the assets (investment) employed to produce this profit.

It should be clear that any profit centre can also be considered as an investment centre because its activities require some form of capital investment. However, if the capital investment is relatively small or if its manager/s have no control over the capital investment, it is more appropriate from a planning and control point of view (and thus also from a budgeting point of view) to treat it as a profit centre.

14.7.2.2 An integrated budgeting system for a manufacturing business

In essence, an integrated budgeting system for a manufacturing business consists of two main types of budget:

1. Operating budgets
2. Financial budgets.

Figure 14.14 shows the operating and financial components of an integrated budgeting system of a manufacturing business diagrammatically.

Operating budgets parallel three of the responsibility centres discussed earlier:

1. **Cost budgets**. There are two types of cost budgets: manufacturing-cost budgets and discretionary-cost budgets. Manufacturing-cost budgets are used where outputs can be measured accurately. These budgets usually describe the material and labour costs involved in each production item, as well as the estimated overhead costs. These budgets are designed to measure efficiency. If the budget is

exceeded, it means that manufacturing costs were higher than they should have been. Discretionary-cost budgets are used for cost centres in which output cannot be measured accurately (for example, administration and research). Discretionary cost budgets are not used to assess efficiency because performance standards for discretionary expenses are difficult to devise.

Figure 14.14: The operating and financial components of an integrated budgeting system

Source: Marx, J. 2019. *Finance for non-financial managers*. Revised third edition. Pretoria: Van Schaik, p. 73. Reprinted by permission of Van Schaik Publishers.

2. **Income budgets**. These budgets are developed to measure marketing and sales effectiveness. They consist of the expected sales quantity multiplied by the expected unit selling price of each product. The income budget is the most critical part of a profit budget, yet it is also one of the most uncertain because it is based on projected future sales.
3. **The profit plan or profit budget**. This budget combines cost and income budgets, and is used by managers who have responsibility for both the expenses and income of their units. Such managers frequently head an entire division or business.

Financial budgets, which are used by financial management for the execution of the financial planning and control task, consist of capital expenditure, cash, financing and balance-sheet budgets. These budgets, prepared from information contained in the operating budgets, integrate the financial planning of the business with its operational planning. Financial budgets serve three major purposes:

1. They verify the viability of the operational planning (operating budgets).
2. They reveal the financial actions that the business must take to make the execution of its operating budgets possible.
3. They indicate how the operating plans of the business will affect its future financial actions and condition.

If these future actions and conditions are undesirable (for example, over-borrowing to finance additional facilities), appropriate changes in the operating plans may be required.

The **capital expenditure budget** indicates the expected (budgeted) future capital investment in physical facilities (buildings, equipment and so on) to maintain its present capacity or expand the future productive capacity.

The **cash budget** indicates:

- the extent, time and sources of expected cash inflows;
- the extent, time and purposes of expected cash outflows; and
- the expected availability of cash in comparison with the expected need for it.

The **financing budget** is developed to assure the business of the availability of funds to meet the budgeted shortfalls of receipts (income) relative to payments (expenses) in the short term, and to schedule medium-term and long-term borrowing or financing. The financing budget is therefore developed in conjunction with the cash budget to provide the business with the funds it needs at the times it needs them.

The **budgeted statement of financial position** brings together all the other budgets to project how the financial position of the business will look at the end of the

budget period if actual results conform to planned results. An analysis of the statement of financial position budget may suggest problems (for example, a poor solvency situation owing to over-borrowing) or opportunities (for example, excessive liquidity, creating the opportunity to expand) that will require alterations to the other budgets.

14.7.2.3Traditional budgeting

Traditional budgeting involves using the actual income and expenditure of the previous year as a basis and making adjustments for expected changes in circumstances. The projected sales serve as the point of departure for the budgeting process. Information must be gathered in order to determine which factors will lead to an increase or decline in sales, as well as factors that will influence cost. Examples of these are inflation, interest rates, exchange rates, wage demands, the actions of competitors and changes to tax legislation.

Applying the concept What to expect in tough times

Retail firms (for example, Edgars) can expect that during times of inflation accompanied by increases in interest rates, the firm's sales could decline, bad debts could increase, the collection of debt could slow down and/or the cost of collecting outstanding debt could increase (as a result of follow-up work). At the same time, the firm has to pay more interest on its loans, pay increased rent on hired retail space and face wage demands. The opposite can be expected during times of declining inflation and interest rates.

The firm's plans and budgets are usually negotiated and finalised during a time-consuming process. A lack of insight into, and commitment to the firm's strategy can cause managers to pursue the interests of their own departments only during this phase, instead of thinking enterprise-wide. Such behaviour leads to suboptimum budgets.

One of the disadvantages of the traditional budgeting approach is that some managers continue the same activities year after year without critically re-evaluating priorities and possible changes in the external and internal environments. This managerial challenge can be handled using zero-base budgeting.

14.7.2.4Zero-base budgeting

In contrast with traditional budgeting, zero-base budgeting enables the business to look at its activities and priorities afresh on an annual basis. In this case, historical results are not taken as a basis for the next budgeting period. Instead, each manager has to justify anew his or her entire budget request.

In theory, zero-base budgeting leads to a better prioritisation of resource allocations and more efficient businesses. In practice, however, it may generate undue amounts of paperwork, and demoralise managers and other employees who are expected to justify their activities and expenses and, in essence, therefore, their existence, on an annual basis.

Critical thinking

The budget dilemma

Is it better for a manager at the middle management level to exceed his or her cost budget at the end of a financial year, or is it better to have funds to spare?

Both are problematic. Exceeding a cost budget could be interpreted as a lack of planning and control on the part of the manager (although there might be valid reasons for exceeding the budget – for example, an increase in activity). Funds to spare are sometimes regarded

by middle management as proof to the top management of how sparingly it has used the firm's resources under its control. However, surplus funds at the end of the financial year may also indicate that the manager intentionally overestimated costs to create the impression that his or her budget is managed well. It may, however, be an indication that the manager did not achieve all the objectives that had been set at the beginning of the year. Unspent funds at the end of a financial year may also result in a reduction of the manager's budget for the following year.

14.8 Asset management: The management of current assets

Current assets include items such as cash, marketable securities, debtors and inventory. These items are needed to ensure the continuous and smooth functioning of the business. Cash, for example, is needed to pay bills that are not perfectly matched by current cash inflows, while an adequate supply of raw materials is required to sustain the manufacturing process. Sales may be influenced by the credit the business is prepared to allow.

Current assets are therefore a necessary and significant component of the total assets of the business. Table 14.7 shows current assets to total assets of Edcon, Sasol, Shoprite and Pick n Pay. Figure 14.15 shows that the ratio of current to total assets may vary from company to company. Retailers such as Shoprite and Pick 'n Pay have a large ratio of current to total assets compared to, say, Sasol, which is listed under the JSE Oil and Gas Exploration and Production sector, and produces fuels and chemicals for the chemical industry. Shoprite and Pick n Pay's large ratio of current to total assets occurs because most of the assets of retail stores are in the form of inventory (current assets). Their main business is trading in inventory, not manufacturing. The chemical industry, in contrast, has large investments in plant and other fixed assets.

In managing current assets, management should always keep in mind the consequences of having too much or too little invested in them. Two factors play a role: cost and risk.

An over-investment in current assets means a low degree of risk, in that more-than-adequate amounts of cash are available to pay bills when they fall due, or sales are amply supported by more-than-sufficient levels of inventory. However, over-investment causes profits to be less than the maximum, firstly because of the cost associated with the capital invested in additional current assets, and secondly because of income foregone that could have been earned elsewhere (the so-called **opportunity cost** of capital). The funds invested in excess inventory could, for example, have been invested in a short-term deposit earning interest at the prevailing interest rate.

An underinvestment in current assets, however, increases the risk of cash and inventory shortages, and the costs associated with these shortages, but it also decreases the opportunity cost.

For example, a business that is short of cash may have to pay high interest rates to obtain funds on short notice, while a shortage of inventory may result in a loss of sales, or even mean that the business has to buy inventory from competitors at high prices to keep customers satisfied. The optimal level of investment in current assets is a trade-off between the costs and the risks involved.

As can be seen from the graph in Figure 14.15, companies differ in their holdings of current assets as a percentage of total assets. Some differences are due to the type of industry. For example, it is evident that Sasol and Edcon have a very low percentage of

current assets compared to Shoprite and Pick n Pay. Sasol is in the petroleum and related industries, while Edcon is mostly in clothing retail, with companies such as Edgars, Jet and CNA. Pick n Pay and Shoprite are predominantly supermarket retailers and have a slightly higher holding of current assets than Edcon and Sasol. In previous years, Pick n Pay differed from Shoprite in its holdings but they are very similar for 2017. This can be attributed to Pick n Pay's new broader diversification of businesses, which is similar to that of Shoprite.

Table 14.7: Current assets to total assets for selected South African companies in 2017

COMPANY	2017 CURRENT ASSETS	2017 TOTAL AS
EDCON	3175	20928
SASOL	16786	115728
SHOPRITE	24643	40533
PICK n PAY	8786	14707

Figure 14.15: The ratio of current assets to total assets for selected South African companies (2017)

Sources: Edcon. *Annual report 2017*. Available at http://www.edcon.co.za. [Accessed 03 December 2018]; Pick n Pay. *Annual report 2017*. Available at https://quotes.wsj.com/ZA/PIK/financials/annual/balance-sheet. [Accessed 03 December 2018]; Sasol. *Annual report 2017*. Available at https://quotes.wsj.com/ZA/SOL/financials/annual/balance-sheet. [Accessed 03 December 2018]; Shoprite. *Annual report 2017*. Available at https://quotes.wsj.com/ZA/SHP/financials/annual/balance-sheet. [Accessed 03 December 2018].

14.8.1 The management of cash and marketable securities

Cash is the money (currency and coin) the business has on hand in petty-cash drawers, in cash registers, and in current and savings accounts with financial institutions.

The costs of holding cash are:

- **Loss of interest**. Cash in the form of notes and coins, and even money in a current account at a bank, earns no interest.
- **Loss of purchasing power**. During a period of inflation, there is an erosion in the value of money. This becomes even more serious if no interest is earned on that money.

The costs of little or no cash are:

- **Loss of goodwill**. Failure to meet financial obligations on time due to cash shortages will seriously affect the relationship between the company and its employees, creditors and suppliers of raw materials and services.
- **Loss of opportunities**. Cash shortages will make it impossible to react quickly to a lucrative business opportunity.

- **Inability to claim discounts**. Discounts for prompt and early payment are very advantageous in percentage terms. Cash shortages may preclude the claiming of such discounts.
- **Cost of borrowing**. Shortages of cash may force a business to raise money at short notice at expensive rates.

Marketable securities are investment instruments on which a business earns a fixed interest income. They can easily be converted into cash and are therefore also referred to as near-cash assets. An example of a marketable security is a short-term treasury bill issued by the government.

There are three reasons for a business having a certain amount of cash available:

1. **The transaction motive**. The transaction motive exists primarily because receipts and disbursements are not fully synchronised. Expenses must often be paid before any cash income has been received. The business needs to have sufficient cash available to meet normal current expenditures such as the payment of wages, salaries, rent and creditors.
2. **The precautionary motive**. The precautionary motive entails the keeping of cash, in addition to that prompted by the transaction motive, for contingencies. Contingencies are unexpected events such as a large debtor defaulting on its account or employees making an unexpected wage demand that may strain the financial position of the business. These funds are usually held in the form of marketable securities or money-market funds that can easily be converted into cash.
3. **The speculative motive**. The speculative motive implies that the business must be able to capitalise on good opportunities such as unexpected bargains and bulk purchases. Additional funds for this purpose are usually also held in the form of marketable securities. A competitor may, for example, be declared insolvent and its inventory sold at bargain prices. The business can capitalise on this opportunity only if it has extra cash available to take advantage of the opportunity.

Cash management is essential for obtaining the optimal trade-off between the liquidity risk and the cost of being too liquid. This is achieved by focusing on the **cash budget** and the **cash cycle**. These two aspects of cash management will now be considered in more detail.

14.8.1.1 The cash budget

Determining the cash needs of a business is an important aspect of cash management. Unutilised cash surpluses or cash shortages result in the cost and risk of the cash investment increasing unnecessarily. Cash-flow problems have been advanced as the primary cause of the demise of several financial institutions, for example, African Bank Limited. Kirkinis, the CEO and shareholder of ABIL, was enthusiastic in his idea that unsecured lending was the saviour in the lives of poorer people. In a column published in the Financial Mail, Kirkinis wrote that ‘unsecured loans enable countless ordinary South Africans to build their homes, educate their children and provide for themselves and their families when faced with unforeseen life events, like the death of a loved one’. CNBC Africa reported in one of its broadcasts that they had information in their possession that the models being used by ABIL to determine provisions for non-performing loans were not robust, citing that ABIL would only declare a loan non-performing after three missed monthly payments. They further alleged that ABIL’s lending criteria were not stringent enough. In May 2013, Kirkinis told CNBC Africa that ABIL had seen an increase in advances even though new loans granted had decreased, indicating an increase in average loan size. It is quite clear that regardless of the extent

of the truth in this story, the reality was that giving more money to people who can't afford to pay you back cannot possibly be a sustainable business model because eventually you will run out of cash and foreclose due to cash flow challenges.

The cash budget facilitates the planning and control of cash. Its purpose is to identify future cash shortages and cash surpluses. The cash budget is therefore a detailed plan of future cash flows for a specific period. It is composed of the following three elements:

1. **Cash receipts**. These originate from cash sales, collections from credit sales and other sources such as cash injections in the form of, for example, bank loans.
2. **Cash disbursements**. These are broadly categorised as cash paid for purchases of merchandise, raw materials and operating expenses such as salaries.
3. **Net changes in cash**. These represent the difference between cash receipts and cash disbursements.

The cash budget serves as a basis for determining the cash needs of a business and indicates when bridging finance will be required. The example that follows shows how the cash budget is used to determine cash needs.

It is clear that the cash budget can be used to identify temporary cash shortages and that this information can be used to arrange bridging finance timeously. It also indicates excess liquidity. This information can also be used to plan temporary investments in marketable securities.

The cash budget for Save Retailers in the box that follows shows, for example, that bridging finance will have to be arranged for April and May, and that arrangements will have to be made to invest the cash surplus that will arise during June.

Applying the concept The cash budget

For Save Retailers there is a 30-day collection period on debtors, which means that there is a lag of 30 days between a credit sale and the receipt of cash. Consequently, cash collections in any month equal the credit sales one month prior. Purchases on credit must also be paid within 30 days.

Table 14.8: Save Retailers

Although one assumes that profit equals an amount held in cash, this is almost never the case. Even a profitable business may not be able to continue its operations owing to a cash shortage. The shortage arises despite growing sales and the accumulation of profits.

14.8.1.2 The cash cycle

The cash cycle in a manufacturing business, as illustrated in Figure 14.16, indicates the time it takes to complete the following cycle:

- Investing cash in raw materials
- Converting the raw materials to finished products
- Selling the finished products on credit
- Ending the cycle by collecting cash.

Figure 14.16: The cash cycle in a business

Wholesalers and retailers are not involved in the second step, but are rather concerned with directly converting cash into inventory. Businesses that offer no credit have no conversion from debtors to cash. As a rule, cash is available only after money has been collected from debtors.

The cash cycle is a continuous process. It should be clear that the demand for cash can be greatly reduced if the cycle is speeded up. This is achieved by rapid cash collections and by proper management of debtors and stock (inventory).

14.8.2 The management of debtors

Debtors arise when a business sells on credit to its clients. Debtors have to settle their accounts in a given period (usually within 30 or 60 days after date of purchase). Credit may be extended to either an individual or a business. Credit granted to an individual is referred to as consumer credit. Credit extended to a business is known as trade credit. Debtor accounts represent a considerable portion of the investment in current assets in most businesses and obviously demand efficient management.

Credit sales increase total sales and income. As pointed out in the management of cash, debtor accounts have to be recovered as soon as feasible to keep the cash requirements of the business as low as possible. Once again, an optimal balance has to be struck between the amount of credit sales (the higher the credit sales, the higher the income and, it is hoped, the profitability) and the size of debtor accounts (the greater the size of debtor accounts and the longer the collection period, the higher the investment and cash needs of the business will be, and the lower the profitability).

In any business, the three most important facets of the management of debtor accounts are as follows:

1. The credit policy
2. The credit terms
3. The collection policy.

The **credit policy** contains directives according to which it is decided whether credit should be granted to clients and, if so, how much. Essentially, this involves an evaluation of the creditworthiness of debtors based on realistic credit standards. Realistic credit standards revolve around the four Cs of credit:

1. **Character** – the customer's willingness to pay
2. **Capacity** – the customer's ability to pay
3. **Capital** – the customer's financial resources
4. **Conditions** – current economic or business conditions.

These four general characteristics are assessed from sources such as financial statements, the customer's bank and credit agencies. Credit agencies specialise in providing credit ratings and credit reports on individual businesses.

Credit terms define the credit period and any discount offered for early payment. They are usually stated as 'net t' or '$d/t1$, n/t'. The first (t) denotes that payment is due within t days from when the goods are received. The second ($d/t1$, n/t) allows a discount of d% if payment is made within t1 days; otherwise the full amount is due within t days. For example, '3/10, n/30' means that a 3 per cent discount can be taken from the invoice amount if payment is made within 10 days; otherwise, full payment is due within 30 days.

The **collection policy** concerns the guidelines for the collection of debtor accounts that have not been paid by due dates. The collection policy may be applied rigorously or less rigorously, depending on circumstances. The level of **bad debts** is often regarded as a criterion of the effectiveness of credit and collection policies.

The costs of granting credit include the following:

•**Loss of interest**. Granting credit is similar to granting interest-free loans. This means that interest is lost on the amount of credit advanced to trade debtors.

•**Costs associated with determining the customer's creditworthiness**. The procedure to determine the creditworthiness of a customer costs money, but fortunately this cost only needs to be incurred once. After the initial screening procedure, the company reassesses the customer on its own experience of the customer's track record of payment.

•**Administration and record-keeping costs**. Most companies that grant credit find it necessary to employ people to administer and collect trade debts.

•**Bad debts**. Unless a company adopts an extremely cautious credit-granting policy, it is almost inevitable that some trade debts will not be paid. Although this risk can be insured against, it still remains a cost to the company.

The costs mentioned above must be considered against the loss of goodwill if credit is denied in a competitive market where customers may obtain the same products on credit terms elsewhere.

Saying 'no' to a customer may be an easy answer, but your competitors may gain a profitable sale. This is not the way to increase turnover and profit.

Source: Posner, M. 1990. *Successful credit control*. New York: BSP Professional Books, p. 1.

14.8.3 The management of stock (inventory)

The concept 'inventory stock' includes raw and auxiliary materials, work in progress, semi-finished products, trading stock and so on, and, like debtors, represents a considerable portion of the investment in working capital. In inventory management, there is once again a conflict between the profit objective (to keep the lowest possible supply of stock, and to keep stock turnover as high as possible, in order to minimise the investment in stock, as well as attendant cash needs) and the operating objective (to keep as much stock as possible to ensure that the business is never without, and to ensure that production interruptions and therefore loss of sales never occur).

It is once again the task of financial management to combine the relevant variables in the framework of a sound purchasing and inventory policy optimally in order to increase profitability without subjecting the business to unnecessary risks.

The costs of holding inventory stock are as follows:

•**Lost interest**. This refers to the interest that could have been earned on the money that is tied up in holding inventory stock.

•**Storage cost**. This cost includes the rent of space occupied by the inventory stock and the cost of employing people to guard and manage the stock.

•**Insurance costs**. Holding inventory stock exposes the business to risk of fire and theft of the stock. Insurance will provide cover against these losses, but this will involve an additional cost in the form of premiums that have to be paid to the insurance company.

•**Obsolescence**. Stocks can become obsolete. For example, they may go out of fashion. Thus, apparently perfectly good inventory stock may be of little more value than scrap.

The costs of holding little or no inventory stocks are as follows:

•**The loss of customer goodwill**. Failure to be able to supply a customer owing to insufficient stock may mean the loss of not only that particular order, but of other orders as well.

•**Production interruption dislocation**. Running out of stock can be very costly for certain types of companies. For example, a motor manufacturer that runs out of a major body section has no choice but to stop production.
•**Loss of flexibility**. Additional stock-holding creates a safety margin whereby mishaps of various descriptions can be accommodated without major and costly repercussions. Without these buffer inventory levels, the company loses this flexibility.
•**Re-order costs**. A company existing on little or no stock will be forced to place a large number of small orders with short intervals between each order. Each order gives rise to costs, including the cost of placing the order and the cost of physically receiving the goods.

Critical thinking

Determining cash flow

It is crucial that businesses estimate their expected cash flows as accurately as possible.

A company collects R1 million per month in October, November and December. The company's cash payments represented 85 per cent of October's receipts, 120 per cent of November's receipts and 95 per cent of December's receipts. On 1 October, the company had a cash balance of R100 000, which also represented its minimum operating needs.

1.Which of the following methods would be used to forecast this company's cash position?
  a.Distribution
  b.Percentage of sales
  c.Time series
  d.Receipts and disbursements
2.Which of the following represents the company's ending cash position for November?
  a.(R200 000)
  b.(R50 000)
  c.R50 000
  d.R100 000
3.In addition to short-term investments, which of the following provides liquidity reserve?
  i.Long-term investments
  ii.Unused short-term borrowing
  iii.Unused long-term borrowing
  a.i only
  b.ii only
  c.ii and iii only
  d.i, ii and iii

14.8.4 Concluding remarks

The discussion of the asset side of the statement of financial position has given only a brief overview of the management of current assets. Only a few fundamental financial implications have been discussed to show how complex the management of current assets is.

14.9 Asset management: Long-term investment decisions and capital budgeting

14.9.1 The nature of capital investments

Capital investment involves the use of funds of a business to acquire fixed assets such as land, buildings and equipment, the benefits of which accrue over periods longer than one year.

Long-term investment decisions determine the type, size and composition of a business's fixed assets, as well as the amount of permanent working capital required for the implementation and continued operation of capital-investment projects.

The importance of capital investments and the capital-investment decision-making process cannot be over-emphasised.

Table 14.9 gives the three major capital-expenditure projects in South Africa with estimated completion dates after 2012.

Table 14.9: Three major capital-expenditure projects

The success of large businesses ultimately depends on their ability to identify capital-investment opportunities that will maximise shareholders' wealth. Conversely, examples abound of business failures because businesses failed to identify opportunities or invested in unprofitable projects.

The importance of capital-investment projects is reflected by the following three factors:

1. **The relative magnitude of the amounts involved**. The amounts involved in capital investment are much larger than those relating to, for example, decisions about the amount of credit to be extended or purchasing inventory.
2. **The long-term nature of capital-investment decisions**. The benefits from capital-investment projects may accrue in periods varying from two or three years to as much as 30 or 40 years.
3. **The strategic nature of capital investment projects**. Investment decisions of a strategic nature, such as the development of an entirely new product, the application of a new technology, the decision to diversify internationally or the decision to embark on rendering a strategic service could have a profound effect on the future development of a business. For example, Honda's decision to branch out from motorcycles to passenger vehicles entirely changed the strategic direction of the company.

14.9.2 The evaluation of investment projects

The basic principle underlying the evaluation of investment decision-making is cost–benefit analysis, in which the cost of each project is compared to its benefits. Projects in which benefits exceed the costs add value to the business and increase stakeholders' wealth.

Two additional factors require further consideration when comparing benefits and costs. Firstly, benefits and costs occur at different times. Any comparison of benefits and

costs should therefore take the time value of money (discussed earlier in this chapter) into account.

Secondly, 'cost' and 'benefits' (income) are accounting concepts that do not necessarily reflect the timing and amounts of payments to the business. The concept 'cash flow', which minimises accounting ambiguities associated with concepts relating to income and costs, is therefore used instead.

14.9.2.1 Cash-flow concepts[2]

Cash flow represents cash transactions. The net effect of cash revenues (sources of cash) and cash expenses (uses of cash) is the net cash flow.

Net cash flow = Cash revenues – Cash expenses

Table 14.10 provides examples of transactions that result in cash inflows (sources of cash) and cash outflows (uses of cash).

Table 14.10: Examples of the sources and uses of cash

Sources of cash	Uses of cash
A decrease in assets	An increase in assets
An increase in liabilities	A decrease in liabilities
Cash sales	
Investment income	Dividend payments to shareholders

Cash flow differs from profit shown on the statement of financial performance in that the latter also includes non-cash costs such as depreciation.

Figure 14.17: Profit and cash flow for ABC Litho Printers

As shown in the representation of the cash flow for ABC Litho in Figure 14.17, the net cash flow is the difference between cash income and cash expenditures. If the net cash flow is positive, it means an inflow of cash and it is referred to as a net cash inflow. However, cash expenditures can also exceed cash income. This results in a negative cash flow and it is then referred to as net cash outflow.

The following three cash-flow components are distinguished for capital-budgeting purposes:

1. **The initial investment**. This is the money paid at the beginning of a project for the acquisition of equipment or the purchase of a production plant. The net cash flow during this phase is negative and represents a net cash outflow.

Example: Depreciation

Assume that a printing business, ABC Litho Printing, buys a printing machine that will last for ten years. The business spends a large sum of money to acquire the machine, but will not spend any significant amounts until the end of the tenth year, when the machine has to be replaced.

It does not make sense to assume that the business makes profits during years one to nine and then incurs a large loss in year ten when it has to replace the machine.

The machine will be used for the entire period, and not only in year ten.

The net profit of the business is adjusted for the use of the machine in years one to nine by deducting depreciation from income. The amount of depreciation is determined by depreciation rules laid down by the tax authorities, as tax is levied on profits after depreciation has been deducted.

However, the cash-flow amount the business has available for reinvestment is equal to the profit after tax plus the depreciation. This amount is the net cash flow into the business.

2. **The expected annual cash flows over the life of the project**. The annual net cash flow can be positive or negative. The net cash flow is positive when cash income exceeds cash disbursements. This represents a cash inflow for the business. The opposite is true when cash disbursements exceed income. This may happen, for example, when expensive refurbishing is required after a number of years of operation and cash income is insufficient to cover these cash expenses.

3. **The expected terminal cash flow, related to the termination of the project**. This terminal net cash flow is usually positive. The plant is sold, and cash income exceeds cash expenses. It may happen, however, that the cost of cleaning up a site is so high that the terminal net cash flow is negative. Think, for example, of a nuclear power plant where the terminal value of the plant is low because of its limited use, but where the cost of disposing of the enriched uranium is very high.

The **magnitude of the expected net cash flows** of a project and **the timing of these cash flows** are crucial in the evaluation of investment proposals on the basis of the present value or discounted cash-flow approach, where the **net cash flow (the cash inflow minus cash outflow) can occur during a specific period or at a specific time.**

For evaluation purposes, it is therefore imperative to approach potential projects in a future-oriented time framework and to present the expected cash-flow stream of a potential project on a time line, as illustrated in Figure 14.18.

The annual **net cash flows** are normally calculated as the profit after interest and tax, plus any non-cash cost items such as depreciation minus the cash outflows for the particular year.

- The **initial investment** (C_0) is the net cash outflow at the commencement of the project at time t_0, usually for the acquisition of fixed assets and required current assets.
- The **annual net cash flows** (operating cash flows) (CF_t) are the net operating profit after tax (NOPAT) plus depreciation. A positive net cash flow means that the cash inflow exceeds the cash outflow. A negative net cash flow implies the opposite.

Figure 14.18: A time line for project Y

- The **life of the project** (n periods or years), also referred to as the economic life of the project, is determined by the effects of physical, technological and economic factors.
- The **terminal cash flow** (TCF) is the expected net cash flow after tax, which is related to the termination of the project, such as the sale of its assets and the recovery of the working capital that was initially required. Depending on circumstances, the terminal net cash flow can again be positive or negative if it

occurs only at the end of the final year of the life of the project life. This is indicated by TCF .

14.9.2.2 The net present value (NPV) and internal rate of return (IRR) methods[3]

NPV and IRR are **discounted cash-flow** (DCF) methods. They involve discounting estimated future cash flows to their present values, and take the magnitude and timing of cash flows into account.

The NPV is the difference between the present value of all net cash inflows (after tax) and the present value of all cash outflows (usually the initial investment) directly related to the project.

The formula for the calculation of NPV is as follows:

The application of NPV involves:

- forecasting the three components of project cash flows (the initial investment, the annual net cash flows and the terminal cash flow) as accurately as possible;
- deciding on an appropriate discounting rate;
- calculating the present values of the above three project cash-flow components for a project determining the NPV of the project (the difference between the present value of the net cash inflows and that of the net cash outflow). The NPV may be positive or negative. The decision criterion is that positive NPVs may be acceptable projects because they will add value to the business; and
- accepting all projects with a positive NPV and rejecting all those with a negative NPV in accordance with NPV decision criteria.

We shall explain the NPV method by means of a practical example by comparing investment proposals X and Y. The information about these projects appears in Table 14.11.

Table 14.11: Information about potential projects X and Y

Notes:

1. The initial investment C_0 at time t_0 is the same for both projects, namely R10 000.
2. In this example, it is assumed that the net cash flow at the end of year five in both cases comprises only annual cash flows and not terminal cash flow.

Assuming that the business's cost of capital is given as 15 per cent, determining the NPV for project Y, for example, involves discounting the estimated net cash inflows at a discounting rate of 15 per cent and subtracting the net cash outflow of R10 000 from the sum of the present value of the inflows.

To form a better idea of the cash flow at each point in time (year-end) over the entire project life, the total cash flows for project Y can be presented on a time line, as illustrated in Figure 14.18 on page 553.

In addition to a **time line**, NPV_x and NPV_y can also be determined by using a tabular format as illustrated in Table 14.11 at a discount rate of 15 per cent. See Table 14.12 for the discounting factors.

At a discount rate of 15 per cent, NPVx is negative and NPVy is positive.

Table 14.12: Discounting factors

Period (n)	Discount rate	
	10%	15
1	0,9091	0,86
2	0,8264	0,75
3	0,7513	0,65
4	0,6830	0,57
5	0,6209	0,49

The **decision criteria** for the NPV are as follows:

•**Accept** projects with a positive NPV (NPV > 0). A positive NPV means that both the initial investment amount and all financing costs, as well as an addition to the value of the business (equal to the amount of the positive NPV), are sustained by the net cash flow of the project. In the case of project Y in Table 14.11, an investment of R10 000 will increase in value to R11 340 in present-value terms.

•**Reject** projects with a negative NPV (NPV < 0). In the case of the example in Table 14.13, the negative NPV of project X means that the net cash flow discounted at a rate of 15 per cent is insufficient to redeem the initial investment amount and the related financing costs. Such a project would consequently have an adverse effect on the value of the business because additional funds (cash) would have to be found elsewhere to meet the shortfall. In the case of project X in Table 14.13, an investment of R10 000 will decrease to R9 386 in present-day terms.

•Projects with NPV = 0 make **no contribution** to value and are usually rejected. For a project with NPV = 0, the given project net cash flow, discounted at the business's cost of capital, is just sufficient to repay both the financing costs of the project and the total amount of financing.

The following questions might now be asked: How should the NPV as a criterion for decisions on investment possibilities be interpreted? And, in short, what does NPV mean in this context?

Assume that the IRR of project X is 12,38 per cent, which is lower than 15 per cent. This confirms the finding of the NPV method: project X will not add value. Assume that in the case of project Y, the IRR is 23,02 per cent and this is greater than 15 per cent, also confirming the finding of the NPV method: project Y will add value.

Table 14.13: Calculation of the NPV for projects X and Y

Example: Probabilities and risk

Throwing the dice is an example of something involving risk. The person throwing knows that the outcome must be a number from one to six. He or she also knows that each number has the same chance of occurrence (one in six), but does not know which number will come up in any particular throw.

14.9.2.3 Risk and uncertainty

The limitation of the above analysis of new investments is that it does not take risk into account.

Risk is defined as any deviation from the expected outcome. Such deviations may or may not occur. Managers are therefore not sure that they will occur, but managers are able to identify the size of the deviations and even the likelihood that they will occur.

Uncertainty, in contrast to risk, describes a situation in which managers are simply unable to identify the various deviations and are unable to assess the likelihood of their occurrence. Most business decisions have an element of uncertainty, but since there is no formal way of dealing with uncertainty, managers focus only on taking risk into account when making capital investment decisions.

14.9.2.4 Concluding remarks

This section has considered the most important aspects of fixed-asset management: the evaluation of potential capital-investment projects and decisions on the desirability of such projects. After briefly looking at the importance of capital investments, the net present value method (NPV) and internal rate of return (IRR) for the evaluation of capital-investment proposals and the riskiness of projects were described.

The NPV is a discounted cash-flow method that takes the timing and the magnitude of cash flows into account. Investment decisionmaking based on the NPV therefore maximises stakeholders' wealth.

Critical thinking

Capital budgeting

Consider the payback period, NPV and IRR techniques.

1. A company is considering the purchase of land and the construction of a new factory. The land, which would be bought immediately, has a cost of R200 000 and the building, which would be erected at the end of the year, would cost R1 000 000. It is estimated that the firm's after-tax cash flow would be increased by R200 000, beginning at the end of the second year, and that this incremental flow would increase at a 10 per cent rate annually over the next ten years. What would the payback period be correct to the nearest number of years?

2. a. Discuss the importance of managing working capital in a retail business. Use an example to illustrate your answer.

   b. What do you understand by the concept 'time value of money'?

   c. What is the difference between the net present value (NPV) and the internal rate of return (IRR)?

14.10 Financing

As indicated earlier, the management of the financing structure is one of the tasks of the financial manager. This entails making decisions about the forms of financing (types of finance) and the sources of finance (the suppliers of finance) to minimise the cost and risk to the business.

In this section, financial markets and the sources and forms of short-term finance will be examined. This will be followed by a discussion of the sources and forms of long-term finance, as well as the cost of long-term capital.

14.10.1 Financial markets

Financial markets and **financial institutions** play an important role in the financing of businesses. The section that follows explains their role.

At a given point in time, an economic system consists of individuals and institutions with surplus funds (the savers) and individuals and institutions with a shortage of funds. Growing businesses require funds for new investments or to expand their existing production capacity. These businesses have a shortage of funds and, to grow, they must have access to the funds of individuals and institutions that do not have an immediate need for them.

- Financial markets are the channels through which holders of surplus funds (the savers) make their funds available to those who require additional finance.
- Financial institutions play an important role in this regard. They act as intermediaries on financial markets between the savers and those with a shortage of funds. This financial service is referred to as **financial intermediation.**
- Financial intermediation[4] is the process through which financial institutions pool funds from savers and make these funds available to individuals and institutions requiring finance.

Through financial intermediation, the individual saver with relatively small savings is given the opportunity to invest in a large capital-intensive business such as a chemical plant. The saver who invests in a business is referred to as a financier. The business rewards the financier for the use of the funds so that the financier shares in the wealth created by the business.

The financier receives an asset in the form of a financial claim in exchange for his or her money. Financial claims have different names and characteristics, and include savings and cheque (call) accounts, fixed deposits, debentures, and ordinary and preferred shares. In everyday usage, these financial claims are referred to as securities or financial instruments.

14.10.1.1 Primary and secondary markets

As indicated above, a saver receives an asset in the form of a financial claim against the institution to which money was made available. These claims are also referred to as securities. New issues of financial claims are referred to as issues on the primary market.

Some types of financial claims are negotiable and can be traded on financial markets. Trading in these securities after they have been issued takes place in the secondary market. This means that a saver who needs money can trade the claim on the secondary market to obtain cash. The Johannesburg Securities Exchange (JSE) is an example of a market on which savers can convert their investments to cash virtually immediately. The tradeability of securities ensures that savers with surplus funds continue to invest. Once issued, they can be traded on the market and the holder may again obtain cash.

Company shares and debentures are examples of negotiable financial instruments, and savings and call accounts are non-negotiable claims.

14.10.1.2 Money and capital markets

The money market is the market for financial instruments with a short-term maturity. Funds are borrowed and lent in the money market for periods of one day (that is, overnight) or for months. The periods of the transactions depend on the particular needs of savers and institutions with a shortage of funds. The money market has no central physical location and transactions are conducted from the premises of the various participants, for example, banks, using telephones or online computer terminals.

Funds required for long-term investment are raised and traded by investors on the capital market. In South Africa, much of this trading takes place on the Johannesburg Securities Exchange. However, long-term investment transactions are also done privately. An investor may, for example, sell shares held in a private company directly to another investor without channelling the transaction through a stock exchange.

14.10.1.3 Types of institutions

As indicated previously, financial institutions interpose themselves as intermediaries between savers and institutions with a shortage of funds by rendering a service to both. Financial institutions are divided into two broad categories: deposit-taking institutions and non-deposit-taking institutions. An example of a deposit-taking institution is a private-sector bank, such as Absa, Nedbank, FNB, Standard Bank and Investec. Non-deposit taking institutions are, for example, short-term insurers (such as Outsurance, Santam and Mutual & Federal), life assurers (such as Old Mutual and Sanlam), pension funds and provident funds.

14.10.2 Short-term financing

The short-term financing decision requires finding the optimal combination of long-term and short-term financing to finance current assets.

As in the management of current assets, risks and costs must be weighed against each other when making this decision. This section introduces different forms of short-term financing. It is followed by a discussion of the implications of a combination of long-term and short-term financing for the financing of current assets.

The following are the most common forms of short-term financing:

- Trade credit;
- Accruals;
- Bank overdrafts; and
- Factoring.

Each of these forms of financing will now be discussed.

14.10.2.1 Trade credit

Trade credit is an important form of finance for businesses and is mainly in the form of suppliers' credit. This means that a supplier does not take payment from the business when products or services are purchased. The business is expected to pay only after 30, 60 or 90 days, depending on the credit terms.

When Pick n Pay, for example, purchases cereal on credit from Tiger Oats (the supplier), it implies that Tiger Oats finances the purchase for Pick n Pay for the period for which the supplier's credit is granted, namely 30, 60 or 90 days.

As shown in Figure 14.19, wholesalers and retailers such as Pick n Pay make extensive use of trade credit as a form of finance because of the nature of their business. Smaller businesses also rely on trade credit because they find it more difficult to obtain funds on money and capital markets. As a rule, trade credit can be obtained quite readily by any business with a reasonable financial record.

Figure 14.19: The use of trade credit as a form of finance – selected listed companies

To ensure prompt payment, the supplier often offers a cash rebate for early payment. This rebate applies only if the buyer pays before a stated date, which precedes the due date of the account.

How do we calculate the advantage of the cash rebate? The following formula can be used:

Management may also decide to delay payment within certain limits. Funds are consequently available to the business for a longer period, which decreases its additional cash needs. This is risky, as the consequence of such a decision could be that the creditworthiness of the business is jeopardised, and suppliers may refuse to supply it in future.

Trade credit offers the following advantages as a source of short-term funds:[5]

- It is readily available to businesses that pay their suppliers regularly and is also a source of spontaneous financing, which is explained in the example that follows.
- It is informal. If a business currently pays its bills within the discount period, additional credit can simply be obtained by delaying payment until the end of the net period at the cost of forgoing the discount.
- Trade credit is more flexible than other forms of short-term financing because the business does not have to negotiate a loan agreement, provide security or adhere to a rigid repayment schedule.

Example: Trade credit

Simeka Retailers purchases an average of R50 000 a day on terms of 'net 30' from Mega Wholesalers. That is, the goods must be paid for within 30 days of the invoice date. This means Mega Wholesalers provides R50 000 × 30 = R1 500 000 in short-term financing to Simeka. Now assume that Simeka's sales – and therefore purchases – double. The trade credit that Mega extends to Simeka also doubles to R3 000 000. Simeka obtains this additional amount of financing virtually automatically – in other words, it is obtained spontaneously.

14.10.2.2 Accruals

As with trade credit, accruals are also a source of spontaneous finance. The most common expenses accrued are wages and taxes.

Accrued wages represent money that a business owes its employees. Employees provide part of the short-term financing for the business by waiting a month or a week to be paid, rather than being paid every day.

Accrued tax is also a form of financing. The level of financing from accrued taxes is determined by the amount of tax payable and the frequency with which it is paid.

Accruals have no associated cost. They are therefore a valuable source of finance because they are cost-free substitutes for otherwise costly short-term credit.

14.10.2.3 Bank overdrafts

An overdraft facility is an arrangement with a bank that allows a business to make payments from a cheque account in excess of the balance in the account. The purpose of an overdraft is to bridge the gap between cash income and cash expenses. An overdraft usually increases through to the month end, when the clients of the business pay their accounts.

An overdraft arrangement is reviewed annually, usually when the annual financial statements become available, so that the bank can evaluate the current financial

position of the business. The interest charged on an overdraft is negotiable and relates to the risk profile of the borrower.

Interest is charged daily on the outstanding balance. This means that the borrower only pays interest on that part of the overdraft that is being used. In contrast to other forms of financing, a bank overdraft is repayable on demand. This means that the bank may cancel the facility at any time.

An overdraft is a flexible form of short-term financing. It is cost effective if used correctly.

14.10.2.4 Debtor finance

Debtor finance consists of factoring and invoice discounting. In contrast to a bank overdraft, debtor finance is, strictly speaking, not borrowing. It is not a loan secured by the book debts of the business. Instead, it involves the sale of debtors to a debtor-financing company.

Invoice discounting is the sale of existing debtors to a debtor-financing company. This company then converts credit sales to cash sales and provides the business with a cash injection by releasing funds that were tied up in working capital. Invoice discounting is usually confidential. In other words, debtors are not advised of the arrangement between the business and the finance company.

Factoring is similar to invoice discounting, but it goes one step further. With factoring, the financier also undertakes to administer and control the collection of debt. In contrast to invoice discounting, debtors are aware of the agreement between the business and the financier.

The financier to whom the debtors are sold is known as the factor. The factor buys approved debtors from the business after carefully examining each account individually. The factor receives commission and interest on amounts paid to the business before the expiry date of the debt. The factor usually pays the business 70 to 80 per cent of the amount outstanding from debtors immediately and the remainder when the debtor pays.

Two common types of factoring practice are:

1. **Non-recourse factoring**. The factor buys the debtors outright and bears the risk of bad debts. The factor accepts responsibility for credit control, debt collection and sales records. Customers pay the factor directly.
2. **Recourse factoring**. In recourse factoring, the factor provides the same services as in non-recourse factoring, but the seller guarantees that debts are recoverable. The factor recovers any bad debt from the seller.

Factoring of debtor accounts has the following advantages:

- The cost of debtor administration is transferred to the factor.
- The turnover of current assets is increased, and less capital is required to finance debtors.
- Liquidity ratios improve.
- More cash is available for other purposes.

The cost of factoring fluctuates according to the conditions laid down by the factor. In considering factoring, the cost should be compared to the savings achieved through not having the administrative liability of debt collection.

14.10.2.5 The short-term financing decision

The cost of short-term funds is generally lower than that of long-term funds. One reason is that trade credit does not really involve a cost. From a cost or profit point of view, it is advantageous for a business to make use of short-term funds for the financing of its

current assets, but too heavy a dependence on them increases the risk of finance not being available when required.

Consider, for example, a financial manager who relies on having short-term debt rescheduled. There is an unforeseen economic downturn, the financial position of the business deteriorates, and the bank manager refuses to renew the business's overdraft. It is clear that the financial manager is faced with a liquidity crisis. A plan will have to be devised to meet the crisis.

The more frequently a business has to refinance its debt, the greater the risk of becoming illiquid. This risk therefore increases as the period for which the debt is granted decreases.

The use of long-term funds to satisfy working-capital requirements has exactly the opposite implications for a business. From a cost point of view, it is disadvantageous because long-term funds are generally more expensive than short-term funds. They will also be underutilised because of the variable nature of portions of working-capital requirements. On the other hand, if more long-term funds are used, there is less risk of funds not being available if and when required.

Figure 14.20 illustrates the following three approaches to the short-term financing problem:

Figure 14.20: Short-term financing plans

1. The **matching approach** (also referred to as the hedging approach) involves matching the period for which finance is obtained with the expected life of the asset. Financing arranged for periods longer than the life of an asset is costly because it is not utilised for the entire period. However, if finance is arranged for a period shorter than the life of the asset, there will be additional transactional costs to arrange for new short-term finance repeatedly. According to this approach, fixed assets and permanent current assets are financed with long-term financing and temporary current assets are financed with short-term funds.
2. In the **aggressive approach**, the financial manager uses more short-term financing than is needed with the matching approach. Permanent current assets are partially financed with short-term funds, instead of using only long-term funds as in the case of the matching approach.
3. In the **conservative approach**, the financial manager uses more long-term funds than with the matching approach. The temporary current-asset requirement is financed with long-term funds. This plan is conservative because it involves the use of a relatively large proportion of long-term funds, which is less risky.

14.10.2.6 Concluding remarks

The choice of a financing plan for a business's current assets entails a trade-off between risk and return. From a cost point of view, it is preferable to finance current assets needs with short-term funds, while risk considerations demand the use of long-term funds.

Critical thinking

Deciding about finance

The cost and risk associated with financing need to be considered carefully.

Assume that Thabeng Enterprises is running into cash-flow problems. It is a privately-owned company. Thabeng can finance its working capital by extending its bank loan or by factoring debtors. Taking risk considerations into account, which would be the most appropriate form of financing for Thabeng?

14.11 Long-term financing

This section focuses on the characteristics of the various forms of long-term financing and the implications of the various sources of financing for businesses.

This is followed by a discussion of the cost of capital and the establishment of an optimal capital structure, with specific reference to **financial gearing.**

14.11.1 Shareholders' interest

Shareholders' interest in a company is subdivided into owners' equity and preference-shareholders' capital.

14.11.1.1 Owners' equity

Owners' equity consists of the funds made directly available by the legal owners (ordinary shareholders) in the form of share capital, as well as indirect contributions in the form of profit retention as reserves and undistributed profits.

- The **ordinary share**. Ordinary shareholders are the true owners of a business. An ordinary share therefore gives right of ownership (right of possession). Shareholders are recorded in an electronic share register or may receive share certificates in exchange for the money they make available to the business.
- There are two types of ordinary shares: **par value shares** and **non-par value shares**. Par value shares all have the same value, while the value of non-par value shares differs. A business can only issue one of the two types of shares, not both.
- A co-owner of the business, the ordinary shareholder, has a claim to profits. The portion of profit paid to ordinary shareholders is known as a dividend. It is paid out in proportion to the shareholding of each ordinary shareholder. The following are important characteristics of the ordinary share:
    - The liability of ordinary shareholders is limited to the amount of share capital they contributed to the business. This means that if the business is liquidated, shareholders may lose this money, but may not otherwise be held liable for its debts. That is why we add the word 'Limited' to the name of a public or private company.
    - Shareholders have no certainty that the money paid for the shares will be recouped, for this depends on the success of the business.
    - Ordinary shares in a listed company (in other words, a public company traded on the stock exchange) can be traded on a stock exchange.
    - Ordinary shareholders are the owners of the business and usually have full control of it in that they can vote at general meetings to appoint directors of the company and on such matters as the amount of dividends to be paid to shareholders. Voting rights are usually in proportion to shareholdings.
    - In contrast to interest payable on borrowed capital, a business has no legal obligation to reward ordinary shareholders in the form of dividends for their investment in shares.
    - Share capital is available to the business for an unlimited period. Ordinary share capital does not have to be repaid. Shareholders may, however, convert

their investments into cash by selling their shares to another investor. South African companies listed on the JSE are allowed to buy back their own shares.

•The issue of additional ordinary shares by an existing company may have the following disadvantages:

»The earnings per share (profit attributable to ordinary shareholders divided by the number of issued shares) of existing shareholders may decrease because the profit attributable to ordinary shareholders does not immediately increase in relation to the increase in the number of issued shares. This phenomenon is known as the dilution of existing shareholders' earnings.

»Existing shareholders may lose control because voting rights are linked to shareholdings, and people other than existing shareholders may take up new shares and become majority shareholders. This danger applies not only to the issue of new shares, but generally also to a business whose shares are listed on a stock exchange and can therefore easily be obtained by others, including competitors.

»The cost of issuing new ordinary shares and the riskiness of an investment in ordinary shares may result in the cost of ordinary share capital being higher than that of other forms of financing.

•Ordinary shares, however, hold some advantages for a business, the following being the most important:

»There is no risk involved for the business because payment of dividends and redemption of capital are not compulsory.

»Additional ordinary shares serve as security for attracting additional borrowed capital, which provides greater flexibility for capital structure decisions. The base of shareholders' capital gives the financial manager the additional flexibility to use a combination of share capital and debt to finance the business.

•Retained profit consists of reserves and undistributed profit, and represents amounts that would otherwise have been paid out to shareholders as dividends. Retained profit is also referred to as self-financing or internal financing. As a form of financing, it holds various advantages for a business:

»No issue costs are involved so it is cheaper than the issuing of additional ordinary shares.

»Capital is immediately available for use.

»It lends flexibility to the capital structure because it serves as security for attracting additional borrowed capital.

»In contrast to the issue of new shares, there are no control implications for existing shareholders.

»It serves as an alternative form of financing if conditions are unfavourable in the capital market as a result of, for example, high interest rates.

»It entails no interest or redemption obligations.

Internal financing is consequently an easy and inexpensive form of financing for a business. However, from the point of view of the owners (ordinary shareholders), it has a serious short-term disadvantage because the retention of profit means the forfeiting of dividends.

Table 14.14: Sources and forms of long-term financing for a business in the form of a company

Notes:

The sources and forms of long-term financing for other forms of businesses differ only in some respects to those for a company:

1. Other forms of business do not have any preference shareholders, and therefore there are no preference shares and no preference-shareholders' capital.
2. The own capital or owner's equity comprises funds that the owner/s contribute to the business, as well as profits that are not withdrawn by the owners. The owners' equity is included in a capital account in the statement of financial position.
3. Other forms of business do not make use of debentures.

14.11.1.2 Preference-shareholders' capital

Preference shares fall somewhere between debentures (discussed later) and ordinary shares in terms of risk. They have some characteristics of both debentures and ordinary shares. If a business is doing poorly, it will first pay debenture holders their required interest and then pay dividends to preference shareholders. Anything left goes to ordinary shareholders.

Two forms of preference shares are distinguished: the ordinary preference share and the cumulative preference share. In the case of the ordinary preference share, shareholders forfeit a dividend if the directors decide not to declare one in a particular year. Cumulative preference shareholders retain the right to receive an arrear dividend in the following year.

A preference share has the following characteristics:

- It has a preferential claim over an ordinary share on profit after tax. In contrast to the dividend on an ordinary share, however, a preference-share dividend is limited to a certain maximum. For example, the holders of a 10 per cent preference share will never receive more than a 10 per cent return on their investment, but could, in bad times, receive no dividend, or one of less than 10 per cent.
- It has a preferential claim over ordinary shares on the assets of the business in the case of liquidation.
- The term of availability is unlimited.
- Authority can vary between full voting rights and no voting rights at all, but usually an ordinary preference share provides no voting rights.

From the viewpoint of the business, preference shares have an advantage over ordinary shares in that their cost is usually lower. For the shareholder, ordinary shares are riskier because preference shareholders have a priority claim on net profit after tax and on assets in the case of liquidation.

14.11.2 Long-term debt

Long-term debt generally refers to debt that will mature (has to be repaid) in a year or more, and can usually be obtained in two ways:

1. Through a loan
2. Through credit.

A loan is a contract in which the receiver of funds (the borrower) undertakes to make interest payments at specified times to the supplier of funds (the lender) and to redeem the total principal sum in payments over an agreed period or on a specific due date.

With credit, the supplier of credit (the supplier of capital) provides the business (the receiver of capital) with power of disposal over an asset and receives extended payments in return, consisting of a principal sum and an interest component. Financial leasing (discussed later) is an example of credit financing.

Some debt instruments (such as debentures, which are discussed later) bear a fixed rate of interest for the period of the debt. In other cases – for example, mortgage bonds

– the interest rate is not fixed, but fluctuates with market forces. This is known as variable interest.

Debt that is secured on one or more assets of the business is known as secured debt. In the event of liquidation of the business, the proceeds from the secured assets would be used first to satisfy the claim of the secured supplier of credit. For example, the holder of a mortgage bond that is secured on any property must be repaid on liquidation before the proceeds from the sale of the property may be used to satisfy the claims of other creditors.

In the case of unsecured debt, a creditor does not have any preferential claim on the assets of a business.

In practice, there are various forms of long-term debt. The most important forms of long-term debt are discussed below.

14.11.2.1 Loans

The following types of loans are of special importance:

- **Debentures** are the most common form of long-term debt in the case of companies. The business (the borrower) issues a certificate to the lender showing the conditions of the loan. This certificate is negotiable, which means that it can be traded on financial markets. Payment of the loan, consisting of a principal sum plus interest, is made to the presenter of the certificate. A debenture has a fixed interest charge and the loan is available to the business over a specified term.
- **Bonds** are secured loans and are issued with fixed assets such as fixed property as security (mortgage bonds). The amount that can be raised depends primarily on the value of the property. Typically, a mortgage bond will not exceed 75 per cent of the value of the property.
- **Registered-term loans** are unsecured loans and, in contrast to debentures, are not freely negotiable. The name of the lender and the credit conditions are recorded in the books of the lender (business).

For a business, loans have the following advantages:

- Costs are limited in that they are determined by the loan interest rate.
- Interest payments are deductible for tax purposes.
- The control of the owners is usually not influenced by the issue of more loans.
- Loans do not dilute the earnings of ordinary shares.

A disadvantage is that the fixed interest obligations and the priority claims of loans in the case of liquidation increase the risks inherent in the business to its owners.

14.11.2.2 Financial leasing

A financial lease is a contract that provides the right to the use of an asset, legally owned by the lessor, in exchange for a specified rental paid by the lessee. The lessor is the party who promises to make the asset available for use by the lessee. A financial lease is a form of credit financing that should not be confused with an operating lease. In contrast to an operating lease, financial leasing gives the lessee the opportunity of owning the asset at the end of the lease. An operating lease can be terminated by giving the required notice, but a financial lease is a non-terminative agreement between the lessee and the lessor. Hence it is a financing agreement (lease) and not an operating-lease agreement.

Two basic forms of financial leasing are the following:[6]

1. **Direct financial leasing** of operating equipment such as motor vehicles and computers. In direct leasing, the lease amount, which is repayable in regular instalments, is determined in such a way that the value of the asset, plus an interest

charge, is paid back by the end of the term of the lease, which is usually related to the lifespan of the asset. Maintenance and insurance of the asset are normally the responsibility of the lessee. Financial leases are used to finance motor vehicles, plants and equipment.

2.**Leaseback agreements** involve assets of a more permanent nature. In leaseback agreements, certain assets that the business owns are sold to the credit supplier and at the same time leased back by the business according to a long-term agreement. Leaseback agreements are usually entered into by businesses that need to raise funds. The assets are generally of a highly specialised nature. The business obtains cash without losing the use of property or equipment through the leaseback arrangement. For example, a dentist may decide to obtain additional funds by financing his or her equipment on a leaseback arrangement. The lease payments of a financial lease are deductible for tax purposes. When the advantages of financial leasing are weighed against ownership through purchase with loan capital, the after-tax costs have to be compared. One should therefore bear in mind that in the case of ownership through the use of loan capital, depreciation, investment rebates and interest payments contribute to tax savings.

14.11.3 Sources of financing for small businesses

It is always sad to see a new business with great profit potential fall by the wayside only because it was not properly financed from the beginning. This happens too often among the thousands of new small businesses started in this country every year. The error comes from either not knowing the total financial needs of the business or failing to provide for those needs in the planning stage.

No business should ever be started without a clear and positive understanding of where its total capital needs are coming from. As has been seen in previous chapters, a very important phase of the entire planning process is to determine what assets will be needed and how they are to be provided. When the amount of the net ownership capital needed has been determined, the proprietors turn to the problem of making sure that the entire amount is available. The total sum should preferably be deposited into the company's bank account before any commitments are made by the new owners.

When several sources of capital are available, the planners must remember that all sources may not be equally desirable. Borrowed capital is shown on the statement of financial position as a liability. It must be paid back at specific periods. These repayments of principal amounts are not operating expenses, which are deducted on the statement of financial performance before planned profits are produced. They are payments for the provision of investment capital and are to be paid out of the profits shown on the statement of financial performance. Many researchers have found that failure to recognise this basic fact is the most common cause of financial strain among small businesses. It is important, therefore, to consider the repayment schedules when choosing among sources of financing.

The various types of financing available to small businesses usually have a similar classification to those of a company, with a few differences and additions. A few of these forms of financing a small business will be discussed in the sections that follow.

Two things should be recognised when one is faced with the problem of obtaining outside capital assistance:

1.An established business with a good record of operations usually has better access to available sources of capital than a new business.

2. Some personal capital available for investment in the business by the owner is almost always essential to obtaining any type of outside assistance.

The possibilities of each of the sources of funds listed will be investigated against this background.

14.11.3.1 Personal funds

Whenever potential creditors, partners or shareholders are invited to invest in or lend financial assistance to a business, their first question is, 'How much does the owner have invested?' Every business contains an element of risk and outsiders who invest in a new business wish to be sure that such risk is shared by the owner. Trading on 'too thin an equity base' means that the owner's investment is too small relative to the investment of outsiders. A financing plan that indicates that the business is starting out on this basis does not usually invite confidence from creditors. As seen in the previous section on capital structure, this does not always mean that the new owners must have 50 per cent of the total capital needs to invest, but it does mean that they should look to other ownership capital rather than only to creditor capital in their financial plan. In any event, it is important that the owners have assets of their own to invest in the business. The closer to 50 per cent of the total capital needs that can be provided, the greater will be their independence and share of net profits.

14.11.3.2 Loans from relatives and friends

Although this type of borrowing to provide original investment capital is generally frowned upon by experienced business operators, it remains a prominent device used in the financial planning of small businesses. Many owners are encouraged in their enterprise by parents, relatives or friends who offer to supply loans to the business to get it started. Quite often, no other sources are available after normal trade credit and supplier contracts have been utilised.

It is unfortunate, however, that many otherwise successful businesses have been beset by troubles because relatives or friends interfered with the operations. Mixing family or social relationships with business can be dangerous. Many such situations might have been averted if the terms of the loans had been more clearly specified, including the rights of the lenders to insist upon making operational policy. The best way to avoid subsequent problems is to make sure that loans are made on a business-like basis. They should be viewed as business dealings. The right of the owner to make decisions should be respected by all parties involved. Arrangements for retiring such loans, including any options for early payment and the procedure if loans become delinquent, should be clearly understood and set out in writing. The owner should be sure such loans are properly presented on the statement of financial position. Payments due in one year are current liabilities; the others are fixed liabilities.

14.11.3.3 Trade credit

Trade credit is the financial assistance available from other businesses with whom the business has dealings. Most prominent are the suppliers of an inventory that is constantly being replaced. It has previously been noted that wholesalers who desire a retailer's business, for example, will offer generous terms for payment of invoices. Manufacturers will do the same for wholesalers whose business they desire. Financing the opening inventory usually represents one of the larger investments in a typical small business. If a R20 000 inventory can be purchased for a R10 000 down payment and the balance in 30 days, the wholesaler has virtually provided R10 000 of the required capital to open the business.

The owner then has an opportunity to sell that inventory at a profit and thus to have the funds to pay off the original balance. As a record for successful operation is established, even more attractive terms may be offered on subsequent purchases. A grocer may have several such suppliers. Other businesses may have only one or two major suppliers. The inducement of a sales discount for prompt payment of invoices should always tempt the owner to pay within the maximum discount period.

14.11.3.4 Loans or credit from equipment sellers

This type of financial aid is often considered another form of trade credit. It does, however, have distinct characteristics. The small business may need counters, shelves, display cases, delivery trucks and other equipment such as air conditioning, refrigeration units and food counters. These, too, are a large investment for the new small business and are recognised as such by the major suppliers of items like these. The purchases, it is hoped, are not made on a regular basis, but represent a large part of the capital needed to get started. The suppliers usually offer good credit terms with a modest down payment and a contract for the balance spread over one, two or three years.

This type of credit, when financing charges are reasonable, can be most helpful to the planner. The caution is in its overuse, remembering, again, that the principal payments must be paid out of profits anticipated. Any principal repayments of this type, too, are for the provision of capital and are not operating expenses. Too much of this type of financing can distort the current and acid-test ratios, and upset the business's financial liquidity. Many cases are on record where the monthly payments on such fixed assets exceed the profits earned from sales in the month.

14.11.3.5 Mortgage loans

If the small-business owners own a commercial building, they can normally secure a mortgage on it with payments over as many as 20 years. This may, for example, be the building in which the new business will operate. In that case, the planners will be making mortgage payments instead of rental payments to a landlord. They may wish to risk a mortgage on their homes. Even second mortgages are sometimes used, although this is not recommended. When profits are uncertain, caution is advised in committing any assets to mortgage claims. As a clear profit pattern becomes more stable and predictable, the use of mortgage credit becomes less risky.

14.11.3.6 Commercial bank loans

Historically, a line of credit at a chartered bank was designed to enable a merchant to purchase an inventory of merchandise. When the merchandise was sold at a profit, the bank was paid its loan. This situation is still followed by many banks. This use of bank credit is still the best way to establish credit with a commercial bank. Since the relaxation of bank restrictions in recent years, however, many other types of loans and financing are now available to qualified applicants. In fact, we now have banks that advertise: 'If you are planning to go into business, come see us.' The cold, hard facts of economic reality will be faced in such a visit, but the prospective business owner with an otherwise sound financing plan, a reputation for integrity and a business deemed likely to succeed may still establish some bank credit in the planning stage.

Short-term loans are usually considered loans over a period not exceeding one year. If adequate collateral is available, longer-term loans may be obtained. Getting influential or wealthy friends to co-sign notes may also be helpful. The policies of several of the chartered banks should always be checked in the planning stage. Many small-business owners with experience have long described banks as 'a place where you can borrow

money when you prove that you don't need it'. Some banks are earnestly trying to remove that image today. In keeping with the previously noted axiom that rewards must be commensurate with cost and risk, however, interest rates charged by banks to small businesses are significantly higher than the rates charged to large businesses.

14.11.3.7Small-business loans

The proprietor of a small business enterprise or a person who is about to establish a new business may borrow funds under this programme for the acquisition of fixed assets, modernisation of premises (leasehold improvements), or the purchase of land or buildings necessary for the operation of the business. The loans are usually provided and administered by the chartered banks and other designated lending institutions such as Khula Enterprise Finance Limited. The loans have fixed terms of repayments of the principal, typically five years. The interest charged on these loans is fluctuating (floating). This rate is usually one or more per cent higher than the commercial bank's prime lending rate.

14.11.3.8Taking in partners

Despite all the necessary precautions, raising capital often necessitates taking one or more partners into the business. If more than one manager is not needed, the new partners may not be employed in the business, but may hold full partner status as a result of their investment in the business. The partnership agreement is important here. Inducements can be offered to such a finance partner, but the duties, responsibilities and authority of each partner must be clearly understood. (At this point, the partnership is being considered only from the standpoint of providing a source of investment funds.)

14.11.3.9Selling capital shares

Aside from the technical, legal and operational advantages of the corporate form of legal organisation, its advantages are greater than the disadvantages as a device for raising capital. Many small-business owners seem to believe that the corporate form was designed only for very large businesses. This is false, however. It is true that this legal form has not been as widely used as it might be, but this is believed to be the result of a lack of knowledge of its advantages.

Consider a new-business planner who needs R100 000 in ownership capital, but has only R30 000 to invest. Would it not be desirable for him or her to go to a local investment dealer as a corporation and request the sale of R50 000 of 7 per cent preference shares and R50 000 of common shares? The owner takes title to R30 000 of the voting common shares and can hold the unsold shares in the business for possible future financing for expansion. The preference share is given a priority of dividends and may not have voting privilege. Usually only the common share has voting power. The owner still owns a majority of the common shares outstanding and has no problem of control. The investment dealer sells the shares to customers who are probably unknown. A detailed study of the plans of the business is contained in a prospectus, which the investment dealer will prepare. The business planner does not have to pursue relatives or plead with friends for financial 'favours', does not have to take in undesired partners to raise capital, has assured a financial plan for expansion, and has all the protection of the corporate form of organisation.

The investment dealer will charge for this service. The charge will be higher if the dealer guarantees the sale of the full amount and less if the shares are sold on a 'best-efforts' basis. The investment dealer's fee is chargeable to organisation expense and can be amortised over the succeeding five to ten years. This procedure is followed by the most informed new business planners who desire growth. It should be investigated for

appropriateness by many new businesses. The raising of funds described above is called 'private placement' of limited share distribution. When stock-market conditions are depressed, this financing route can be an important alternative to the public distribution of the company's shares, also known as 'going public'.

14.11.3.10 Venture-capital funding

Small businesses may sometimes (albeit not too often) qualify for investment funds from venture-capital businesses. These companies provide equity and loan capital to potentially high-growth small companies. An example is Khula Equity Scheme. Khula has set up regional venture-capital companies to invest a minimum of R1 million in small businesses needing significant equity investment.

When applying to a venture-capital business, it is absolutely essential to provide it with a comprehensive business plan. If this plan passes the first screening, the venture capitalist will investigate further and examine, with due diligence, the product, the technology, potential market share, competitive situation, financial requirements and projections and, most importantly, the competence of management. After the venture capitalist decides to make an investment, it will usually do so in return for part ownership in the business (common or preference shares) and/or by the provision of a direct loan with share-purchase options. Typically, a venture-capital business will not seek a controlling interest in the business. However, it will try to protect its investment by being able to assume control if the small business gets into financial trouble.

14.11.4 Concluding remarks

In the discussion above, the forms and sources of long-term financing available to a business were briefly analysed. The question that now arises is how the financial management of a business can combine the various forms of financing in the most efficient way. This consideration will now receive attention.

14.12 The cost of capital

Profitable and growing businesses continually need capital to finance expansion and new investment. Because of the costs involved in using capital (dividends to shareholders and interest paid to credit suppliers), financial management must ensure that only the necessary amount of capital is obtained, and that the cost and risk are kept to a minimum.

In attracting capital (one of the main tasks of financial management), the various forms of financing must be combined in a mix that results in the lowest-possible cost and lowest risk for the business.

The cost of capital is of crucial importance in both capital-investment decisions and financing decisions:

- In capital-investment decisions, the cost of capital is used to evaluate investment proposals. The cost of capital was assumed as given in the calculation of the net present value (NPV) in this chapter.
- In financing decisions, the various types of capital earmarked for financing the investments of a business should be combined so that the cost of capital to the business is kept to a minimum.

14.12.1 Risk

For an investor, risk consists of two components:

1. The possible loss of the principal sum (the original amount invested).

2.The possibility that no compensation will be paid for the use of the capital (no interest or dividend payments).

Any action that increases the possibility that the principal sum might be forfeited (as in the case of liquidation) or that compensation (in the form of dividends) will not be paid increases the risk for the supplier of capital. The use of borrowed capital such as debentures increases the possibility that dividends might not be paid and therefore increases the risk to ordinary shareholders.

14.13Summary

This chapter began by examining the nature of the financial function and the tasks of financial management, as well as the relationship between financial management, the other functional management areas, related subject disciplines and the environment. Thereafter, various concepts generally used in financial management, as well as certain techniques employed by financial management, were explained. The goal and fundamental principles of financial management were also explained. Finally, one of the tasks of financial management, namely financial analysis, planning and control, was outlined.

The chapter explained the management of the asset structure of a business – in other words, short-term investment decisions (managing current assets) and long-term capital-investment decisions. Rational and purposeful decisions in these areas ensure to a large extent that the goals of the business are pursued as effectively as possible. Some important guidelines and techniques for both types of investment decisions were presented, bearing in mind that current and fixed-asset management are totally integrated in practice.

The nature and characteristics of the various forms of long-term capital were discussed. This was followed by a discussion of the factors involved in establishing the cost of capital. The long-term financing decision based both on the various forms of long-term capital as well as on the risk involved was explained.

This brief overview of financial management aimed to put into perspective the interesting and important facets of financial management, as well as the challenges and complexities of this functional area of management. Bear in mind, however, that the various aspects of financial management are all interrelated and integrated in the course of business operations, and that the function of financial management should be performed with full awareness and in the context of all other functions of the business.

Small business perspective

Small businesses also have a financial management function, but it has a different implication and impact and is characterised by different problems and opportunities. First, most small businesses are not listed on an organised exchange like the JSE Ltd in order to sell shares to external parties to raise capital. Small businesses do not issue bonds. Bonds are debt instruments sold in order to raise external capital. These investors hold these instruments for long periods (from five years and upwards), in exchange for interest on a regular basis, and the repayment of the principal amount at maturity. Small businesses are usually run by entrepreneurs, who rely primarily on trade credit provided by suppliers of the product or service that the small business is selling. On rare occasions, financial or government institutions do provide financial support in the form of bank loans, overdrafts or grants. However, banks will usually charge interest and demand some form of security or collateral on the money lent to the business. This security can be in the form of any asset or asset owned by the owner that the bank considers being of value. Other forms of financing available to the small business are lease financing, hire purchase agreements (for example,

purchase of office furniture), instalment sale agreements (for example, purchase of a motor vehicle), personal equity and personal loans from the owner, friends and relatives. A small business, therefore, faces a much more severely restricted set of financing alternatives than those available to the large corporation.

KEY TERMS	
assets	internal rate of return
bad debt	liability
break-even analysis	liquidity ratios
budgeting	net present value
capital	non-current asset
cash flow	opportunity cost
cost of capital	ordinary shares
current asset	preference shares
debt	present value
default	profit
equity	risk–return
expenses	shareholders' interest
financial gearing	statement of financial performance
financial institutions	statement of financial position
financial intermediation	time value of money
future value	working capital
income	

Questions for discussion

1.How would you respond if you were the owner and manager of a business and the quarterly financial reports started showing your firm was making a loss?
2.Looking at the financial statements of your firm, you notice the net profit is not equal to your bank balance on 28 February. How do you explain this?

3.How would you determine whether it is financially viable to start your own business?

4.A group of managers discuss financial planning. ‘Compiling a budget is a waste of time. The business environment is simply too unpredictable’, says one manager. Another manager responds, ‘You must work according to a plan. Yes, your results will not match the budgeted figures 100 per cent, but failing to plan is planning to fail’. What is your view?

5.One of your fellow students remarks that you can only be a good financial manager if you are a chartered accountant (CA). Would you agree or disagree? Why?

6.Two of the ratios that are used to evaluate the management of current assets are the current ratio and acid-test ratio. Assume a firm has a current ratio of 4:1 and an acid-test ratio of 3:1. Are these ratios indicating that the firm is managing its current assets well or could they possibly be indicating some problems?

7.Should a firm increase its sales for credit rather than for cash during periods of recession? Why not?

8.Which alternatives could a firm’s management pursue if the firm’s cash budget indicates a negative cash flow during the following six months?

9.Which other alternatives are there for evaluating risk while doing capital budgeting?

10.During periods of rapid economic growth, interest rates are relatively low compared to relatively high interest rates during periods of recession. How would this influence the feasibility of capital expenditure?

11.Which factors affect the level of gearing at which your organisation operates?

12.Explain what you understand the term ‘cost of capital’ to mean.

Multiple-choice questions

1.You are to receive an amount of R1 000 two years from now. However, if you had received the amount today and invested it, you would have been able to earn 10 per cent interest per annum on the amount. What would the amount be worth if you could receive it now instead of waiting two years?

a.R785

b.R805

c.R826

d.R854

Use the following information to answer Question 3 and Question 4:

Income statement for the year/Statement of financial performance	
Sales	6 543 876
Less cost of goods sold	4 384 396
Gross profit	2 159 480
Less operating expenses	1 190 653

Operating profits	968 827
Less interest expense	98 400
Net profit after tax	870 427
Less tax (28%)	243 720
Net profit after tax	626 707
Distributed as follows:	
Dividends to ordinary shareholders	250 683
Retained earnings	376 024
	626 707
Additional information:	
Number of ordinary shares	2 506 830
Current price of share	500 cents

2.Gunn & Moore manufactures cricket bats at one of its plants. The fixed cost amounts to R1 600 000 per annum. The bats are sold at R400 each and the variable cost per unit amounts to R150. The break-even point of this plant is __________ units.

a.2 909
b.2 300
c.4 000
d.6 400

3.The firm's return on investment (ROI) is equal to ________ .

a.7,33%
b.8,03%
c.9,58%
d.10,9%

4.The firm's current ratio is equal to __________ and shows __________ management of the liquidity, because it __________ be able to pay its creditors promptly.

a.1,7:1, good, will
b.2,0:1, reasonable, should
c.5,0:1, good, might

d.5,0:1, poor, might not

5.ABIL Ltd has made an initial investment requiring R4 210 879. The firm's cost of capital is 14% and the net annual cash inflow is expected to be R1 453 644 per annum for five successive years. The net present value of the investment is closest to _______ .

a.R201 357
b.R499 048
c.R779 599
d.R2 757 235

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CHAPTER 15

Purchasing and supply management

Hannie Badenhorst-Weiss

The purpose of this chapter

The purpose of this chapter is to place the purchasing or sourcing function and its role in an organisation and supply chain into perspective, and to explain the management, process and most important activities of the function in a changing environment.

Learning outcomes

On completion of this chapter you should be able to:

- place the purchasing and supply function, and the nature of purchasing and supply activities in an organisation and supply chain into perspective
- explain the role and importance of the purchasing and supply function in the success and efficiency of a business
- explain the application of the management functions of planning, organising and control in the purchasing and supply function
- illustrate and explain the logical steps to be followed in a purchasing and supply transaction
- indicate the role of the purchasing and supply function in quality decisions
- explain the role of quantity decisions in the purchasing and supply process
- give an overview of the selection, management and development of suppliers
- pinpoint certain aspects of pricing as purchasing and supply activity
- place the right time for purchasing and supply in perspective.

15.1 Introduction

This chapter provides a perspective of the fundamentals of the purchasing and supply function in the organisation. This function has become more important in the last two decades due to its strategic position in the supply chain and the supply chain management approach adopted by most modern organisations, including government institutions.

A supply chain is a network of organisations linked to each other through buying and selling of materials, products or services. If a supplier has problems and cannot deliver materials, products or services to its customer, the customer might experience a shortage of materials, products or services. This might lead to an interruption of operations, which result in an interruption of supply to the next customer in the chain. It is therefore important that there is a close relationship between organisations (buyers and suppliers) in a supply chain. There are many supply chain management strategies and principles that organisations in supply chains apply to get the maximum value with the least input of resources throughout the supply chain. These principles, such as supplier alliances, supplier development, quality assurance of products/services (for example, total quality management or TQM), optimum inventory levels and

reducing cycle times and cost, will become clear in the discussion of the content of the chapter, both in the examples and the opening case study. The purchasing function is a strategic function in the organisation ensuring the effective management of the supply side of the organisation, hence the link with suppliers higher up in the supply chain.

CASE STUDY: TFG in the Foschini Group invest in local suppliers

The South African clothing industry is characterised by long product development and manufacturing lead times, poor reliability (on average only 63 per cent of manufacturing orders are delivered on time and in full to retailers) and low stock turnover. South African clothing retailers' cycle time is five to six times slower than the best in the world. The Foschini Group Ltd is a retail group that trades mainly in clothing, as well as in jewellery, accessories, sporting and outdoor apparel and equipment, cellular goods and services and home ware. The Foschini Group employs 27 825 workers throughout South Africa and attained sales income of 31,11 billion rand in the last financial year (2017–2018). TFG Manufacturing is Foschini's manufacturing arm for clothing, supplying a large percentage of the retail group's garments. TFG is one of South Africa's biggest clothing manufacturers. Unlike most other retailers, who buy clothing from stand-alone manufacturing companies, TFG is 100 per cent owned by Foschini and is located within the firm's Cape Town head office complex. It employs more than 250 people across five design and manufacturing units and supplies the Foschini group with exclusive in-house designed brands.

A strategic objective of TFG is to obtain competitiveness within the local supply chain in terms of the need to reduce cycle times, improve efficiencies and reduce waste. This enables TFG to increase the percentage of orders on a quick response (QR) timeline, resulting in an enhanced rate of sale and a reduced markdown. TFG is committed to prioritising local supply chain development and focus on creating shared value in both financial and social terms within their local supply chain operations. By achieving this they aim to increase disposable household incomes by uplifting local communities through job creation, job retention, training and upskilling.

One of TFG's biggest achievements in 2016–2017 was the positive recognition of the value of local suppliers. Subsequently their retail brands have increased their proportion of QR and accordingly benefited from an improved sales performance. They have made significant increases in the volume of their QR garments. Total garments manufactured on this timeline increased by 26 per cent from FY 2016 to FY 2017. TFG has and continues to optimise its local supply chain capability with a number of development initiatives:

- Enhancing local design capability and capacity through a number of initiatives gives TFG Design an improved ability in designing and reacting to demand in-season sales.
- Growing the capability and capacity of TFG Manufacturing; they have built two world-class QR manufacturing facilities which employ over 1000 employees. They have, through two competitiveness clusters, had six years of upskilling their local manufacturers to better manage the lean process requirements for QR manufacture.
- TFG Manufacturing focuses heavily on skills upgrading at all levels in their local supply chain and partners, and this has ensured that they stay technologically abreast in both information technology systems and sewing machine technologies.
- QR scalability and sustainability with ever improving timeliness required an increase in the capacity and capability in the dyeing, printing and finishing of fabrics.
- TFG has just launched a new 'Competitiveness Improvement Cluster' which focuses on the critical aspect required to effectively scale QR. The essential local trim and fabric conversion process has required them to expand, develop and improve their identified strategic value chain partners.
- TFG's developmental approach applies across the full value chain, linking fabric mills, manufacturers, auxiliary suppliers, Prestige Clothing, TFG Design and all of TFG's retail brands in creating sustainable, social and financial value.
- Learning, mentoring and partnership activities, as well as specific strategic support, will continue in their efforts to develop a substantial local QR capability.

In order to support the additional QR capacity, the new TFG quick response (QR) Prestige Clothing manufacturing facility in Caledon opened in January 2017. This facility has been equipped with the most advanced sewing machine equipment. Additionally, the ratio of employees in this facility who have attained a national qualification as opposed to those who have not, given its size, is currently the best in the national clothing industry. This world-class facility, both in layout and process, has attained efficiency levels resulting in price points that compare favourably with Chinese competitors. Savings are also made in every aspect of the business, including the use of green energy and energy saving technology. Both Prestige Clothing facilities – Maitland and Caledon – achieved another A grade internal scorecard performance status.

Sources: TFG Integrated Report, 2017. Available at http://tfg-integratedreport2017.co.za/downloads/; Bisseker, C. 2014. The business of fashion. *Financial Mail*. http://free.financialmail.co.za/07/0907/features/dfeat.htm.

Consumers need to make purchases on an almost daily basis to satisfy their day-to-day needs. They make large purchases, such as buying a motor car or a house, to satisfy their long-term needs. In the same way, a business also has to make purchases to meet its daily and long-term needs. Because people make purchases almost every day, the value of the **purchasing and supply function** in business is often underestimated. There is a perception that anyone is capable of making purchases for a business.

However, purchasing and supply in a business entail far more than merely comparing the prices of two or more competitive bids and then buying material from the supplier that offers the best prices and service. Buyers or purchasers in a manufacturing business buy a great variety of materials. These materials range from stationery, cleaning agents, cafeteria services and globes to bulk fuel, strategic material (which is sometimes difficult to obtain) for production processes, and equipment for office and production processes. Buyers are also involved in the purchase of capital goods – for example, robot-controlled processing equipment and complicated computer systems.

Buyers are expected to keep abreast of better substitute materials, new developments and technology in the market. A buyer's expertise can improve the progressiveness, productivity and profitability of a business. Buyers often have to make trips abroad or develop local **suppliers** because of the lack of existing sources (the TFG case study is an example of developing a local supplier). They also have to ensure that materials purchased meet quality requirements because this has an effect on the quality of the business's final product (in the case of a manufacturer) and the quality of products resold (in a retail business). Buyers need to be aware of market trends, seasons and the state of the market. They should, for example, know how many suppliers and how many buyers are present in a particular market, as this has a crucial effect on the purchase price of materials, the way in which suppliers should be approached and the type of relationship required.

Organisations make different kinds of purchases. For example, Eskom purchases coal, water, copper cable, poles, materials, parts and services (for example, civil and electrical engineering, cleaning and security services) for the construction and maintenance of power plants and office buildings, motor vehicles, computer systems, office equipment, stationery, legal services, training services and transport services, and consumables such as toilet paper, cleaning materials and refreshments.

Woolworths purchases merchandising and materials-handling equipment (for example, shelves, trolleys, baskets and refrigerators), products for selling in its retail shops (for example, perishable products such as fruit, meat and dairy products), groceries, clothing products, home products (crockery, cutlery, curtains and bedding), computer systems, office

equipment, stationery, legal services, training services and transport services, and consumables such as toilet paper, cleaning materials and refreshments.

In a small to medium-sized security gate manufacturing business, the purchasing function is responsible for purchasing various gauges of iron rod, locks, paint, welding equipment, cleaning services, stationery, etc. In a small- to medium-sized women's clothing boutique, the purchasing function is responsible for purchasing the garments, fashion jewellery, purses and scarves, and shop equipment such as chairs, tables, display cabinets and shelves, refreshments, credit control and security services, etc.

The **purpose** of the purchasing and supply function is not only to provide the right materials, services and equipment, but also to ensure that they are purchased at a reasonable price, satisfy quality requirements and are received in the correct quantities at the right place and time. The activities of the purchasing and supply function are derived from this.

The purchasing and supply function should:

- select suppliers;
- purchase and arrange for the transport of materials to the business;
- determine the quantity and quality of materials or services;
- decide what prices to accept;
- expedite and receive materials;
- control warehousing and inventory-holding; and
- determine the timing of purchases.

To perform these activities optimally, the purchasing and supply function needs to be managed, that is, planned, organised and controlled.

Purchasing and supply management

Purchasing and supply management entails the planning, organising, leading and controlling of all activities relating to the purchase of materials and services from an external source. It is aimed at maintaining and improving the business's sustainability and efficiency[1] of customer service.

Business sustainability is often defined as managing the triple bottom line – a process by which companies manage their financial, social and environmental risks, obligations and opportunities. These three impacts are sometimes referred to as profits, people and planet. (http://lexicon.ft.com/Term?term=business-sustainability).

15.2 The importance of the purchasing and supply function to the business

The importance of the purchasing and supply function differs from one business to the next, but in most businesses, purchasing has a profound influence on the financial performance and other aspects of the business, which are discussed below.

15.2.1 Greatest expenditure for the business

Purchasing costs are a business's biggest expense, especially in businesses where final products are purchased, for example, a corner shop, a boutique, a liquor shop or a hardware shop and no actual value is added to the product. In retailing businesses such as Foschini, Spar or Edgars, for example, up to 90 per cent of each available rand may be spent on purchases. It therefore stands to reason that purchasing costs is an area in which cost savings can make a vital contribution to the business's financial performance.

A further example is the automotive industry. The purchasing costs contribute to more than 80 per cent of a Honda motor car's final price. The cost of steel, tyres, glass, paint, fabric, aluminium, copper and electronic components represents more than 60 per cent of the final price of the motor vehicle. In the soft drinks industry purchasing costs contribute 65 per cent of the price of a bottle of Coca-Cola. These include the cost of bottles, caps, cans, packaging materials and transportation.

15.2.2 Inventory-holding

Stock is held to prevent disruptions in the transformation process (production or operational) that would be caused by an interruption in the flow of materials to a business. The aim of **inventory management** is to keep inventory levels as low as possible without risking an interruption in the operational process (as a result of an out-of-stock situation). The reason for this is that large sums of operating capital are tied up in inventory. This capital could be applied elsewhere to earn revenue. If too much capital is tied up in inventory, a business could encounter cash-flow problems. This is a particularly serious problem for small businesses, which are often characterised by limited capital investment and available cash (discussed in Chapter 14). Besides cash-flow problems, warehousing costs are a big cost element, usually ranging from 10 to 25 per cent of total investment in inventory.[1]

Warehousing costs include the costs (interest) of financing warehousing, warehouse staff, insurance and obsolescence. Effective purchasing and supply management can reduce inventory-holding by ensuring an uninterrupted flow of materials or products of the right quality to the production process (or consumer products to the retail outlet) at the time when they are needed. The more reliable the provision or purchase of materials or product is, the smaller the amount of inventory that needs to be stored. Inventory and inventory-holding are discussed in more detail later in the chapter.

15.2.3 Contributions to the marketing of products

By purchasing materials of the right quality and price at the right time, a manufacturer, such as the security gate manufacturer, can make the right final products available, in the right quantities at a reasonable price at the right time to its customers. A retail buyer, for example in a fashion boutique, has a greater and more direct influence on the marketing of merchandise (for example, clothing) where the availability of the right product (type, quality, style and brand) at the right time in the right quantities is an important consideration in successful marketing. Effective purchasing can therefore facilitate the marketing of a business's products and contribute indirectly to the financial (or economic) performance of the business through the marketing function.

15.3 The management task of the purchasing and supply manager

In Part 2 of this book, you were introduced to the general management principles of planning, organising, leadership and control. As was mentioned earlier, purchasing and supply, like all other functional areas (marketing, finance, operations and so on), must be managed to ensure that the purchasing and supply function operates effectively and makes the best possible contribution to the sustainability of the business and efficient customer service. In the sections that follow, the application of the main management elements of the purchasing and supply function (planning, organising and control) will be addressed without discussing the principles in detail.

15.3.1 Purchasing and supply planning

Essentially, the planning of the purchasing and supply function means 'managing the purchasing and supply function for the future'. Purchasing and supply planning entails formulating purchasing and supply objectives, which the purchasing and supply function should strive to reach by a particular future period, and drawing up purchasing and supply plans to achieve these objectives. These plans should include the optimal application of resources (people, physical facilities and funds) to achieve the objectives.

The planning of the purchasing and supply function, like planning in the business itself and other functional management areas, takes place at the following levels (see Chapter 7):

- **Strategic level**. At this level, planning entails the purchasing and supply manager providing input to business planning. The elements of strategic purchasing and supply planning differ from one business to the next. Where the purchasing and supply function is deemed to be less important and merely involves a clerical function, the purchasing and supply function is not involved in strategic planning. When a business has accepted the supply-chain management approach, purchasing and supply will be involved in strategic planning. Planning at strategic level is normally of a long-term nature. It is aimed at safeguarding materials provision, developing supplier sources and maintaining the competitive position of the business. Typical strategic planning elements are supplier alliances, supplier development, supply-chain process integration, availability forecasting, and purchasing and supply policy.
- **Tactical or middle-management level**. This type of planning may cover the medium-term needs of the business, including budgeting, the purchasing and supply system and organisation thereof, purchasing and supply methods, negotiation, development of human resources, interface development with other functions and suppliers (by means of cross-functional teams), contracting and employing cost-reduction techniques.
- **Operations level**. At the lowest operations level, plans are formulated to allow the daily functioning of the purchasing and supply function to proceed as smoothly as possible. This benefits the business as a whole, as well as other functions serviced by the purchasing and supply function. Planning at this level is of a short-term nature. It includes planning the tasks of expediting, keeping records, maintaining the purchasing and supply system, invoice clearance, handling of requisitions, enquiries and quotations, and pricing decisions.[2]

In a small business, the management of the purchasing function will usually be done by the owner. When the strategic and tactical management is done correctly, operational personnel can do the planning on an operational level.

The formulation of objectives is one of the most important planning tasks. Table 15.1 provides an indication of the purchasing and supply objectives that can be derived from the business's objectives.

Table 15.1: Purchasing and supply objectives derived from business's objectives

Business objectives	Purchasing and supply objectives
To retain the market share.	To search for more unique products in the supplier market.

To move from the speciality market to the general market.	To seek new and larger suppliers, and develop a newmaterials fl handle larger quantities and a greater variety of items while keep inventory volume as low as possible.
To develop specific new products and services.	To seek or develop new suppliers.
To develop an overall production capacity plan, including an overall make-or-buy policy.	To develop systems that integrate capacity planning and purchas planning, together with a policy of make-or-buy.
To initiate a cost-reduction plan.	To standardise materials and reduce suppliers.

15.3.2 Organising the purchasing and supply function

Chapter 8 has an in-depth discussion of organising as an element of management. The focus in this section is merely on the application of organising in the purchasing and supply function.

Purchasing and supply organisation

Purchasing and supply organisation involves the creation of a structure of responsibility and authority for the purchasing and supply function, and the organisation of purchasing and supply activities to realise purchasing and business objectives.

There are four main issues that need to be addressed in organising the purchasing and supply function:

1. The place of the purchasing and supply function in the organisational structure.
2. The internal organisation of the purchasing and supply function.
3. Co-ordination with other functional management areas.
4. Cross-functional teams (organising the purchasing and supply function according to the supply chain management approach).

In small- and medium-sized businesses, the purchasing of important items will most probably be performed by the owner/entrepreneur, while less important items, such as cleaning materials and refreshments, will be purchased by one of the clerks.

15.3.2.1 The place of the purchasing and supply function in the organisational structure

The place of the purchasing and supply function in the business is affected by two elements: **centralisation or decentralisation**, and the **hierarchical level** of the purchasing and supply function in the organisational structure of the business.

CENTRALISATION OR DECENTRALISATION

In a business with a centralised purchasing and supply function, the purchasing and supply manager and his or her personnel have the authority and are responsible for the purchasing and supply function. In an organisation with a single business unit, as in a typical small to medium-sized business, this is the obvious organisational structure. However, if an organisation has a head office with different business units, branches or plants, there are various options, including the following:

- A centralised purchasing and supply function, situated at head office, is responsible for purchasing.

- Each plant or branch does its own purchasing, which means that the purchasing and supply function is organised on a decentralised basis.
- A combination of centralised and decentralised functions is used, with some materials and services bought on a centralised basis and other materials on a decentralised basis.

Figure 15.1: Business with a centralised purchasing and supply structure

A **centralised purchasing and supply structure** has certain advantages. One advantage is that the standardisation of purchasing and supply procedures as well as materials or services purchased is possible. Standardisation has great cost-saving advantages. For example, a greater volume of materials of one kind being purchased from a supplier results in lower inventory levels and lower prices because of better discounts for volume orders. Because of volumes, purchasing and supply personnel can concentrate on buying a specific commodity (material or service), which makes specialisation possible. A centralised purchasing and supply organisation is especially suitable if the needs of different business units, plants or branches are much the same, as is the case, for example, with all Pick n Pay hypermarkets. If the greatest proportion of a business's purchases is made from a single supplier or a few suppliers, and if the material is of strategic importance to the continuation of the business's activities, it is preferable to purchase on a centralised basis. Figure 15.1 illustrates a centralised purchasing and supply structure for a multi-plant business.

A **decentralised purchasing and supply structure** is particularly suited to a business comprising geographically dispersed plants whose purchases are made from a number of their local suppliers, such as the different mines that belongs to Anglo American Corporation or other large mining groups. Also, if the plants perform divergent activities and therefore have unique needs in terms of purchases, decentralisation is the obvious choice. Where the different decentralised plants are regarded as profit centres, it is necessary for each plant to have autonomy over its own expenditure – hence, in this case, decentralisation of purchasing and supply is the right option. A decentralised purchasing and supply structure has the advantage that buyers have closer contact with internal consumers and local suppliers, and reaction times to the requests of users are quicker. Figure 15.2 depicts a decentralised purchasing and supply structure in a business with various plants.

Figure 15.2: Business with a decentralised purchasing and supply structure

A **combination of centralisation and decentralisation** is a useful middle course. In this application, the centralised purchasing office purchases collective requirements, enters into long-term contracts on behalf of the whole business, purchases capital equipment, formulates purchasing and supply policy and strategies, trains buyers, and evaluates decentralised purchasing and supply performance. Decentralised purchasing and supply provides for the specialised needs and small purchases of the plant. The buyers report directly to the head of the plant, but operate within the parameters of

policy laid down by the centralised purchasing and supply authority. Figure 15.3 shows a centralised/decentralised purchasing and supply structure.

Figure 15.3: Business with a centralised/decentralised purchasing and supply structure

Applying the concept A combination of centralised and decentralised purchasing and supply

At Telkom, the head office negotiates large contracts with suppliers of copper cable, optical fibre and microwave dishes. Decentralised regional offices buy non-strategic items such as tools, maintenance materials and services from local suppliers.

THE HIERARCHICAL LEVEL OF THE PURCHASING AND SUPPLY FUNCTION IN THE ORGANISATIONAL STRUCTURE

The hierarchical level of the purchasing and supply function is primarily determined by the importance of the purchasing and supply function to the business. The importance of the function is determined by the following factors, among others:

- **The value of the purchased materials in relation to the total expenditure of the business**. The greater purchasing's share of total expenditure, the more important the purchasing and supply function is. (Refer to section 15.2.1). If only this factor is taken into consideration, one could say that purchasing and supply is more important in a retail organisation than in a manufacturing business. However, it is not the only factor that determines the importance of purchasing and supply.
- **The situation in the supplier market**. If the supply market is a monopoly (only one supplier) or an oligopoly (only a few suppliers), as is the case in certain markets in South Africa, negotiation should take place at a high level to negotiate the best value for the business. Purchasing and supply is important here, and the head of the purchasing and supply function should put forward proposals and operate at a high level in the business.
- **The size of the business.** In larger businesses, the purchasing and supply manager is usually placed on the same level as other functional managers, such as the marketing manager, the financial manager and the operations manager. In smaller businesses, the purchasing and supply function often falls under the financial manager or the marketing manager.
- **The nature of the materials purchased and the specialised knowledge and skills of buyers**. This determines the status of buyers and the purchasing and supply manager in the business. For example, in the purchase of technologically advanced custom-made materials, the buyer needs in-depth technical knowledge, as well as negotiating and commercial skills. However, when it comes to purchasing cleaning agents and stationery, no special knowledge or skills are required.
- **Top management's perception**. The top management's perception of the importance of the purchasing and supply function will determine its status in the organisation.

15.3.2.2 Internal organisation of the purchasing and supply function

The purchasing and supply function can be organised internally in a variety of ways. The organisation may consist of an **informal structure** in which buyers purchase any

material or service and process whatever requisitions or enquiries are placed on their desks. In such a case, the buyer is responsible for the whole spectrum of activities, from asking for quotations or calling for tenders to the expediting and receipt of the product. Conversely, the function can be divided into **specialist groups** in which each person takes responsibility for buying a specific material or service. In a larger business, the function can also be split so that a buyer is responsible for all the purchases from a specific supplier, especially in the case of strategic materials.

In the case of the purchase of a specific commodity or material, the buyers concerned may develop into specialists who come to know the product and supplier market extremely well, thus bringing large-scale cost benefits for the business. A buyer who is responsible for purchasing from a specific supplier can build up a long-term relationship with that supplier. Developing open and personal relationships with suppliers of scarce or strategic materials is especially important.

15.3.2.3 Co-ordination with other functional management areas

Traditionally, co-ordination was regarded as a management task. However, this book follows the latest trends and sees co-ordination as part of organising. Therefore, little mention is made here of co-ordination.

However, the purchasing and supply function needs to co-ordinate with other functions in the business and with the business's suppliers. The purchasing and supply function cannot make an optimal contribution to the objectives of the business and the supply chain in isolation. Co-ordination of the purchasing and supply function occurs at three levels:

1. Various purchasing and supply activities must be co-ordinated internally in the purchasing and supply function.
2. The purchasing environment (suppliers) must be co-ordinated with purchasing and supply activities.
3. The purchasing and supply function must be co-ordinated with other functional management areas such as finance, marketing and production, and eventually with the needs of the final consumer.

Purchasing and supply co-ordination

Purchasing and supply co-ordination may be regarded as the conscious effort to harmonise the activities of the purchasing and supply function, the activities of other functional areas and the activities of suppliers in ways to ensure full co-operation in the pursuit of purchasing and supply objectives.

Open communication, conscious motivation, and standardisation of specifications, procedures and documentation are aids to improve co-ordination internally in the purchasing and supply function, in the business itself and externally with suppliers. Strategic alliances with suppliers and integrated systems are important aids for co-ordination. The just-in-time (JIT) system, the materials-requirements planning system (MRP), quick response (QR) and other systems plan and control the inventory and materials-flow process. They are also important co-ordinating instruments within the purchasing and supply function and the business, and with suppliers. Small suppliers to big organisations, such as food suppliers to Woolworths or parts and module manufacturers to automotive supply chains such as Toyota or Nissan, are usually connected to the systems of their large customer. These systems will assist the small suppliers by indicating what these small suppliers purchase, and the timing of the purchases, enabling them to manufacture and deliver the final goods on time to the large supplier.

15.3.2.4 Cross-functional sourcing teams

Cross-functional sourcing teams

A cross-functional sourcing team consists of personnel from at least three functions brought together to execute a purchasing related (materials or services) assignment or solve a purchasing-related problem.

The use of cross-functional sourcing or purchasing teams is an important practice in purchasing and supply. The purchaser co-operates in a team with colleagues in other functional management areas to perform numerous tasks, which include development of specifications, supplier selection, negotiating corporate-wide purchasing agreements, developing cost-reduction strategies, developing sourcing strategies, developing suppliers and the evaluation of suppliers' performance. Purchasers are also involved in other teams that have been assigned specific tasks, such as value analysis and the development of new products.

The objectives of using cross-functional sourcing teams are to obtain a wide perspective on problems, to stimulate innovative thinking and to obtain the best value for the organisations and the customers. The teams may be permanent, or they may exist only for a specific period, or until a specific task or project has been completed. Suppliers can be included in a functional team for certain tasks such as new product development or the establishment of quality standards. To be a member of a cross-functional team, a buyer must have the ability to work with groups and display leadership qualities.

15.3.3 Control in the purchasing and supply function

Purchasing and supply control, like control in other functional management areas of a business, is the measure adopted to ensure that purchasing and supply objectives are pursued within acceptable and accepted standards or norms and guidelines. This is done according to a specific policy established during purchasing and supply planning. Purchasing and supply planning and, more specifically, the formulation of objectives, is therefore the first step in the control process. The steps comprise setting objectives, setting criteria and norms, measuring actual performance, comparing actual performance with the norms, studying deviations and taking corrective measures (if necessary). The steps in the control process were discussed in detail and illustrated in Chapter 10. Areas of control in the purchasing and supply situation, however, require further investigation. The management task in the purchasing and supply function, and the performance of purchasing and supply activities, need to be evaluated (controlled).

15.3.3.1 The assessment of purchasing and supply management

The **management** performance of the purchasing and supply function should be evaluated, just like other activities of the purchasing and supply function, because management can influence the overall job performance and achievement of the purchasing and supply function and, ultimately, the performance of the business. Management is intangible and difficult to measure quantitatively. Therefore, there is a certain amount of subjectivity in measuring management.

An evaluation sheet or questionnaire can be used to assess management performance in purchasing.[3] This may include aspects such as:

- the leadership shown in the introduction of new ideas, systems, approaches or strategies;
- the number or percentage of purchasing contracts established;

- the knowledge and skills to lead the purchasing and supply function in an increasingly complex purchasing environment;
- the relationships established with strategic suppliers;
- the adequacy of performance appraisal and control systems in the purchasing and supply function;
- the contribution to cross-functional teams;
- the role in the establishment and management of supply chains;
- the effectiveness of the use of the total purchasing leverage of the firm; and
- the appropriateness of purchasing and supply policies, procedures and practices.

In a small business the management part of purchasing is usually done by the owner or entrepreneur. He or she will not be formally evaluated for his or her purchasing decisions or practices, due to the fact that he or she is the entrepreneur who was responsible for the existence of the business, and therefore will be innovative when it comes to best purchasing practices. The whole business and his or her investment depend on this.

15.3.3.2 The assessment of purchasing and supply activities

As was mentioned earlier, the aim of the purchasing and supply function is to supply the business in the most effective way with the right materials of the desired quality, quantities and price at the right place and time. To realise this objective, the purchasing and supply function has to perform certain activities. Control is necessary to ascertain whether these activities are being performed **effectively**. The following control points or criteria can be used to gauge the effectiveness of purchasing and supply activities:

- **Price proficiency**, by, for example, comparing actual prices with planned (budgeted) or market prices, the number and value of discounts negotiated for a specific period, and determining which part of every rand turnover constitutes purchasing costs.
- **Supplier performance**, by, for example, noting rejected orders, orders received late and the number of times it was necessary to expedite the process.
- **Timeliness**, by, for example, noting the number of orders indicated as urgent and the number of operations interrupted or rescheduled as a result of shortages.
- **Cost-saving**, by, for example, comparing costs with those of previous periods.
- **Workload**, by, for example, looking at the number of orders and requisitions.
- **Purchasing costs**, by expressing administrative purchasing costs as a percentage of the monetary value of purchases.
- **Inventory-holding**, by calculating inventory turnover, and making further enquiries into inventory losses and obsolescence of stock.
- **Relationship performance** with suppliers, by means of a survey or scrutiny of supplier turnover, or number of alliances formed.
- **Relationship with other functional management areas**, by monitoring the diligent execution of requests to the purchasing and supply function, and the contribution purchasers make in cross-functional teams.

Once these measurement criteria have been laid down, the actual results can be measured and compared with a standard or norm such as past performance or the results of similar businesses. A report on performance and problem areas should be compiled and submitted to top management with the necessary recommendations. (Review the steps in the control process in Chapter 10.)

15.4 Purchasing process and activities

Although each purchasing and supply activity is discussed separately in this chapter, this does not mean that purchasing and supply activities exist or are performed in isolation. In fact, the different purchasing and supply activities are often executed simultaneously and are interdependent. Price and quality, price and time, price and choice of suppliers, and time and quantity are inseparably intertwined. The practical execution of purchasing and supply activities is clear from the discussion of the stages in the purchasing and supply process or cycle.

15.4.1The purchasing process

The discussion of the purchasing and supply process or cycle in this section provides a clear picture of the steps in the purchasing and supply transaction, how the steps follow each other logically, who in the business is involved in each step and the documentation involved in each step. Not all the steps are necessarily taken in each purchasing and supply transaction, and some steps may take place simultaneously.

A large number of businesses in South Africa have computerised their purchasing and supply process. Computerised systems are also based on the purchasing and supply cycle discussed here. Computerisation expedites the process considerably and usually reduces the documentation involved.

Figure 15.4 reflects the basic steps in the purchasing and supply cycle, the functional management areas involved, and the documentation used.

The steps of the purchasing and supply cycle are explained in more detail below:

•**Development and description of a need**. Because of the activities of other functional-management areas such as marketing and operations (also called 'users' or 'consumers'), there is a need for products, materials and services. The need is conveyed by means of a requisition, order card, or materials and specification list to the purchasing and supply function. To ensure that the desired products, materials or services are purchased, the buyer must take careful note of the specification, which is actually a description of the need. The specification describes the material and the required quality of that material. The buyer should also look closely at the quantities specified and the date on which the material or service is required. In a manufacturing business, the greatest need is for materials and services in the production or operational function. In a retail organisation, the greatest need is for merchandise (inventory items) in the marketing function (merchandising).

Critical thinking

What would happen if the consumer or functional departments did not describe their needs for materials or services clearly on a requisition? What would happen if a purchaser did not analyse the requisition carefully?

•**Choice of suppliers**. The choice of the right supplier is the principal activity of the purchasing and supply function. This choice is discussed in more detail later. The complexity of the decision depends on various factors – for example, whether it is a new purchase or a repurchase, whether a contract needs to be entered into or already exists, or whether standard or specialised materials are required. Depending on the factors, the buyer will use documents such as the supplier register, order forms, contracts, price lists, quotations or tenders. In a new buying situation, especially where a contract has to be drawn up, determining the present and future availability of the materials or services is a vital consideration in the choice of supplier. Determining the future availability of materials or services is no easy task.

A study of the technical, managerial and financial abilities of suppliers, their progressiveness, idle capacity and past performance (if the business has used that supplier previously) is necessary. This is done by analysing the financial statements of suppliers, making personal visits and conducting interviews with their staff and management, and obtaining credit bureau reports. It is important to note that user functions (for example, marketing or production) may make recommendations about a particular supplier, but the final choice rests with the purchasing and supply function.

Figure 15.4: Steps in the purchasing and supply cycle of a commercial business

Critical thinking

How would the decision process on suppliers differ if a construction firm purchased maintenance materials, iron rods, cement and consulting engineering services?

- **Research on prices and availability**. This is actually part of the previous step. The prices of standard materials or services and materials or services with a low monetary value are determined with the aid of price lists and telephonic, verbal or written quotations. Because standard materials or services are available everywhere, prices are in fact determined by competition. The prices of non-standard, specialised materials or custom-made items are often determined by tender or quotation in conjunction with negotiations.
- **Issuing the order and concluding a contract**. The order and the contract are important documents because they spell out unequivocally to the supplier the needs of the business and the conditions of the purchasing transaction. They also constitute a legally valid contract to which both parties are bound by law. The order or contract should contain specific conditions for the transaction in respect of quantities, quality, prices, discounts, delivery dates, customs clearances and exchange-rate clearances.
- **Follow-up and expediting**. The purchasing and supply function's task is completed only when materials or services of the right quality and quantity have been received at the right place, and, most importantly, at the right time. One of the administrative tasks in the purchasing and supply function is to determine whether materials are received, or services are performed in good time. If not, or if they are overdue, the supplier should be reminded (by email, telephone or electronically if a computer system links the business and its suppliers) that it has not adhered to the clauses of the contract and that it should concentrate on the speedy delivery of required materials. The importance of this task is often underestimated. If a supplier is late with deliveries, this can interrupt the production or operational process in a manufacturing business or leave a retailer with empty shelves. This can also have serious implications for supplier relations and the continued use of a specific supplier.
- **Receipts, inspection and distribution**. Stores reception (as a subfunction of purchasing and supply) is responsible for checking the quantities and condition of materials when they are received and compiles an inspection report. The materials are sent to the users (that is, the functions that requested the products) with a copy

of the order or they are taken up as inventory in the stores. In the case of services, the specific users who requested the services need to compile a report on the performance of the service provider.

- **Handling errors and discrepancies**. Communication and keeping good relations with suppliers are important tasks of the purchasing and supply function. If defective materials are received or services are performed poorly, the purchasing and supply function should communicate with the suppliers concerning these in a way that will prevent future defective consignments, but still ensure good relations.
- **Paying for the order**. It is the task of purchasing and supply to prepare authorisation for payment of the supplier. The purchasing and supply function checks the delivery note, the inspection report, the invoice and the order to confirm that the quantities, quality, price and discounts are correct, and to verify the calculations. It then authorises the finance function to pay the supplier. The purchasing and supply function should execute this task carefully and quickly so that suppliers are paid in accordance with the payment policy of the business.
- **Closing the order**. Once the supplier has been paid, the purchasing and supply function must file all documents pertaining to the particular transaction or incorporate them into a system for future reference. This is a crucial part of the evaluation of a supplier's performance. It also constitutes an assessment of the purchasing and supply function's performance.

This discussion of the purchasing and supply cycle has placed in perspective the principal purchasing and supply activities: decisions about quality and quantities, choosing and managing suppliers, pricing, decisions about purchasing, and supply times. The next step is to examine these activities in greater depth.

15.4.2 Quality decisions as a purchasing and supply activity

15.4.2.1 The role of quality in purchasing

The four main factors in each purchasing and supply decision are quality, supplier service, delivery and price. Quality is probably the most important of these factors. Even if the price and the service that a supplier offers are outstanding, material or services will not be bought from the supplier if the quality is in any way lower than required because the material or service will not perform the function for which it was purchased.

Quality is an inseparable part of other purchasing and supply activities. Top quality is normally associated with high prices and vice versa. Quality also determines the number of suppliers. The higher the quality requirements are, the fewer suppliers there will be to satisfy such requirements. Quality of materials also influences inventory-holding or the quantity to be purchased. In the case of high-quality requirements, a reliable supplier that can meet the specification and deliver on time will be chosen. Smaller volumes of materials can therefore be kept in stock because fewer materials will be rejected during inspection. In fact, continuous high quality is an absolute necessity in stockless systems such as **quick response (QR)**, just-in-time (JIT) and materials-requirements planning (MRP), which are discussed in section 15.4.3.3.

The quality of purchased products and services rests on the following considerations, which will be discussed in the next section:

- Determining the right quality for a given goal;
- Describing quality so that both the buyer and seller understand it clearly; and
- Controlling quality to ensure that requirements are met.

15.4.2.2 Determining the right quality

A buyer has a different perspective of the concept ‘the right quality’ from the perspective of a technical person. From a purchasing and supply perspective, the right quality can be defined as follows:

Definition

The right quality is that quality that is purchased at the lowest price, which satisfies a specific need and performs the function for which it was purchased.

For **engineers and designers**, technical considerations such as job performance and reliability are often the only factors that are important. It frequently happens that engineers and designers request the purchase of the highest- or best-quality materials or services without any commercial considerations, when lower-quality materials or services would do the job just as well. Buyers are more attuned to commercial considerations such as the right quality, availability, price and delivery. A buyer should therefore have the right to question technical requirements or to request that **specifications** be reconsidered on the strength of commercial considerations.

The best quality is therefore not necessarily the right quality. The right quality for a specific purchase is determined by balancing suitability (technical requirements), availability and cost (commercial requirements).

The end-user and/or the marketing function also often provide input on suitable quality, since the right quality materials not only increase the productivity of the user, but also influence the quality and price of the final product to be marketed.

The quality of products is important for marketing as well as for customer relations and public image because quality influences the image the business wants to project and is decisive in determining which customers wish to associate with the business and its products. After-sales service, a policy on taking back materials or service of a poor quality, and the provision of guarantees by the supplier are important considerations that tie in closely with decisions pertaining to quality. Suppliers also play a vital role in determining suitable quality because they are often in a position to recommend alternative materials or services.

Critical thinking

Would purchasers in the motor-assembly industry query the quality of parts to be installed in the engine of a motor car?

15.4.2.3 Description of quality

Quality refers to measurable qualities, a condition or characteristics of materials or service usually expressed according to grade, class, brand or specifications. It should be possible to describe the desired quality, otherwise the person requisitioning the material or service cannot communicate clearly with a buyer, or the buyer cannot communicate with a supplier, about what exactly is required. (For communication purposes, the description of quality is entered on the requisition and order.) The description of quality is also important because it serves as a measure for judging the quality of incoming materials by means of inspection or the evaluation of services performed. The following methods and forms should be noted:

- **Specifications are the most general method of describing quality**. A specification is a description of non-standard materials or services that are able to perform a certain function. Specifications for materials can be drawn up according to dimensions or physical features such as tolerance, work ability, uniformity and chemical composition. For services, other dimensions will be used, such as the

nature of the service and a step-by-step exposition of actions, timelines and required outcomes for each step.

•**Standardisation is a further aid in describing quality**. It is, in effect, the process of making materials, methods, practices and techniques uniform. Standardisation can be set by a business or organisation, or nationally or internationally by an industry, and it has several advantages. If a business or organisation standardises materials, total inventory can be reduced because fewer kinds and qualities are kept. Standardisation also improves collaboration between the user and buyer in a business, and communication between the buyer and supplier. Industrial and international standards make possible the mass production of products. Because many suppliers manufacture standard products and standard materials can be bought everywhere, competition in the market is increased, and the purchasing and supply price of the product is reduced.

•**Other forms** of quality description are market grades, brands, SABS (South African Bureau of Standards) standards, engineering drawings and samples.

Critical thinking

What is the value of standardisation in a franchise group such as Steers? Has standardisation any value in a women's fashion boutique? If so, in what way does it have value?

15.4.2.4Control of quality

It is imperative to control the quality of incoming materials and purchased services. Poor-quality materials and services interrupt the manufacturing process, expose workers to danger, have a detrimental effect on the final product, and ultimately reduce the satisfaction of end-users and alter the perception they have of the business and its products.

Inspection is the normal process used to control quality. It is a method that ensures that the measurement, design, job performance and quality of materials or services received satisfy the standards or specifications on the order. It also ensures that products or services are suitable for the purpose for which they have been ordered. Inspection is a technical process. It is not the task of purchasers but must be carried out by the quality-control function or the function where purchased services are performed.

During inspection by quality controllers, samples of delivered materials or services are subjected to tests. However, inspection in itself is not enough to guarantee the quality of incoming materials or services. If the purchasing and supply function buys from a supplier that has maintained top-quality standards for years, it is unnecessary to inspect its products or services. In such a case, the business can negotiate a **supplier-certification agreement** with the supplier. Based on agreed terms, the supplier and the buyer's quality-control functions work together for a specific time. The materials and operation processes are subject to intensive inspection for a certain period. After this, the supplier is certified, and it becomes responsible for quality assurance.

The SABS has a certification scheme whereby enterprises are encouraged and supported in endeavours to establish and operate quality-control systems or quality-assurance programmes. Part of the certification scheme of the SABS is the well-known ISO 9000 to 9004 and ISO 14000 international standards. The establishment and operation of such programmes by suppliers is extremely costly. Since the quality of materials or services is assured, buyers will be prepared to pay high prices, particularly when high quality is crucial.

15.4.3 Deciding on purchasing and supply quantities

15.4.3.1 The need for inventory-holding

The purchasing and supply function would be able to buy the exact quantity of materials required at a certain time if all of the following criteria were met:

- The operations function was 100 per cent certain of the quantity of materials to be used in the manufacturing process.
- The marketing function was 100 per cent certain about how many products were going to be sold.
- There were no supply problems in the supplier market.
- The incoming materials completely satisfied quality requirements.

Unfortunately, such a situation simply does not exist in practice. Marketing and production or operations budgets are based solely on estimates. Certain supplier markets in South Africa tend to be unreliable with regard to delivery and quality (refer to the garment supply market in the opening case study). Consequently, the buyer has to purchase more materials than required to prevent a possible shortage when the materials are needed. The result is that inventory-holding becomes necessary. Inventory-holding is therefore inextricably intertwined with the tasks of a buyer.

A worldwide trend is to keep minimum inventory. The reason for this trend is that inventory-holding generates considerable costs and ties up large amounts of operating capital.

One of the main aims of contemporary approaches such as supply-chain management and the concomitant enablers (for example, supplier alliances, quick response (QR), JIT, MRP, enterprise resource planning (ERP), efficient consumer response (ECR), automatic replenishment (AR), and e-procurement) is to limit inventory-holding to the minimum.

If the holding of inventory is so unpopular, why should inventory be held at all? There are two major reasons for this:

1. Inventory-holding helps to ensure that the operations process (or the marketing process in a retailing organisation) can continue without interruptions resulting from shortages of materials.
2. It allows businesses to utilise cost savings through longer production runs and volume discounts.

It is therefore clear that too little or too much inventory is undesirable. Both conditions have certain cost implications or disadvantages. Table 15.2 provides a summary of some of the implications of too little or too much inventory.

Table 15.2: Implications of inventory positions

Disadvantages of too much inventory	Disadvantages of too little inventory
Operating capital is tied up, with the resultant opportunity and interest costs.	More urgent orders with concomitant higher transport costs, and strained relations with s
Losses in terms of depreciation, obsolescence, damage and theft.	Higher unit prices as a result of smaller orde
Costs in terms of storage space (rental or interest), more warehouse staff and equipment, and bigger insurance	Cost of production or job interruptions and th accompanying strained relations with users

premiums.	the business.
	Lost sales because of empty shelves in the r organisation and the resultant negative impa business's image.

Critical thinking

Why should fuel companies and electricity generation plants (for example, Eskom) keep more stock rather than less stock? Why should a retailer such as Edgars or Fruit & Veg City not keep too much stock?

15.4.3.2Inventory costs

Certain costs increase when large quantities of stock are purchased, while other costs decrease. It is necessary to categorise these cost elements and examine them more closely to determine optimal inventory quantity, that is, the inventory quantity that results in the lowest total cost of inventory.

Inventory-carrying costs are those costs that are involved in keeping inventory. They include the cost of storage, salaries of warehouse staff, insurance, property tax, obsolescence, wear and tear, theft, interest charges (for the financing of inventory) and opportunity costs (loss of income from investment in alternative profit-bearing projects, as capital has been invested in inventory). Larger order quantities cause larger inventory levels and therefore higher inventory-carrying costs. The opposite applies to small quantities and lower inventory levels.

Inventory-ordering costs are the costs of placing an order. Ordering costs include the salaries of purchasing and supply and expediting personnel, stationery, telephone costs, online (e-procurement) costs, inbound transportation and postage. Larger purchasing and supply quantities result in fewer orders being placed and a decline in ordering costs.

Total inventory costs consist of the sum total of inventory-carrying costs and inventory-ordering costs. Ordering costs decline and carrying costs increase as order quantities increase. Ordering costs increase (because more orders have to be made) and carrying costs decrease as order quantities decrease. The influence of quantity on the two cost categories is indicated in Figure 15.5. The lowest total inventory cost is achieved where the two curves (carrying cost and ordering cost) intersect – in other words, when ordering costs are equal to carrying costs. The number of units opposite the lowest total inventory cost on the graph is the most economic order quantity (EOQ).

Figure 15.5: The economic order quantity

15.4.3.3Inventory-control systems

Inventory should be managed and controlled so that optimal inventory levels can be maintained. This means that inventory should be kept at such a level that the best service can be rendered to the user or customer at the lowest possible cost. The quantities that are ordered each time should keep inventory at this optimal level. Most

inventory-control systems are based on the principles of one of the systems described below.

THE SYSTEM OF FIXED-ORDER QUANTITIES

This system is based on the principle that each time new inventory is required, a fixed quantity (the EOQ) is ordered. The system is represented visually in Figure 15.6.

The EOQ is ordered once inventory reaches a certain level (order point B) as a result of the use or selling of inventory items (A to B). Inventory is then replenished by ordering the EOQ to reach the maximum inventory level. The order level is determined in such a way that inventory does not become depleted during the delivery period of the order (lead time).

The system is advantageous because attention is focused only on a specific item when the inventory level reaches the ordering point and the same quantity is ordered every time. However, the system is unsuitable for items whose consumption or lead times are unreliable.

Figure 15.6: The system of fixed-order quantities

Applying the concept The fixed order quantity system of a book publisher

A publisher may decide that when there are only 100 copies of a certain book in stock (level B), 3 000 copies need to be printed (that is, a fixed order quantity) to bring inventory up to level A. A buffer stock (for example, 50 books) is also kept as a precaution against unforeseen and exceptional circumstances.

Critical thinking

Decide which of the following two situations the fixed-order quantity method would be more suitable for:

- A security-gate manufacturer who delivers standardised security gates for large retail groups such as Makro and Builder's Warehouse or
- a retail shop such as Foschini.

THE CYCLICAL-ORDERING SYSTEM

According to this system, each item in the inventory is checked or reviewed at fixed intervals and is supplemented by an order to bring the inventory level to its maximum level again. Thus, the ordering times are fixed, but the order quantity varies, as shown in Figure 15.7. The system is suitable for seasonal materials or materials that are used on an irregular basis, but where the acquisition of such materials can be planned far in advance on the basis of sales forecasts, for example, in a clothing store. This system is used in grocery stores where, at the end of every week or month, stocktaking is done for each product on the shelves and the order quantities are adjusted to the quantity on the shelves. Thus, for example, more soft drinks are ordered every week or month during summer than in winter.

Figure 15.7: The cyclical ordering system

THE MATERIALS-REQUIREMENTS PLANNING (MRP) SYSTEM

MRP is a computer-assisted system used in complicated production processes such as automotive parts manufacturing, where the aim is to maintain minimum inventory levels. The system uses a computer to calculate the total need for materials that may be required by an operations process in a given period. The planned quantity of final products to be manufactured during the production or operations process in the given period is broken down into components and materials by the computer. It then determines the total need for each type of raw material and component, with due consideration for lead times, so that materials or components are received when the production process needs them. The advantage of the system is that inventory levels are low. However, the system works only if suppliers are extremely reliable with their delivery and quality. Contracts with suppliers are usually needed to keep this system going.

Critical thinking

Can MRP work if certain materials used in the production process need to be imported? What influence will the importation have on the inventory (stock) levels of the specific materials?

THE JUST-IN-TIME (JIT) SYSTEM

This is, in fact, a production- or operations-scheduling system and not an inventory system. It virtually eliminates the holding of inventory. Its operation is based on requiring suppliers to deliver materials of the right quality to the business on the day they are needed and where they are needed – in other words, just in time. The system requires regular deliveries and quantities should correspond exactly to needs. In other words, it is not the inventory system that determines the quantities to be purchased or to be delivered, but the operations or production system. Therefore, purchasing and supply has little or no influence on the quantities to be purchased. It is imperative for purchasing and supply to work closely with operations management because the purchasing and supply function needs to be fully conversant with the changing needs of the operations system.

The JIT system works properly only if the suppliers are extremely reliable and are integrated into the business's production or operations system. Supplier alliances are needed to make JIT work. The JIT system cannot satisfy all the needs of the business. Only materials used in the operations process are purchased according to the JIT approach. Requirements that do not relate to the manufacture of the business's final product (for example, office and operations equipment and maintenance materials) obviously do not justify the use of the sophisticated JIT system and concomitant attention to the supplier base.

Critical thinking

Toyota is a company well known for using the JIT system. Toyota South Africa imports many parts and modules from Toyota Japan. How do you think the earthquake and tsunami on 11 March 2011 in Japan affected the JIT-system employed by Toyota South Africa?

THE QUICK-RESPONSE (QR) AND AUTOMATIC-REPLENISHMENT (AR) SYSTEMS

Quick response (QR) is defined as a vertical strategy in the supply chain in which the manufacturer strives to provide products and services to its retail customers in exact quantities on a continuous basis with minimal lead times, resulting in minimum inventory levels throughout the retail apparel supply chain, such as in the opening case study in the Foschini TFG Group. QR can be regarded as the retail version of the manufacturing JIT concept. The system aims to deliver materials or merchandise to areas in the exact quantities required at the precise time they are needed. With JIT, the use of raw materials pulls raw materials into the production process. With QR, merchandise (retail products or consumer items, such as garments) is pulled by customer sales (point of sales). In both cases, information about the production rate or the sales figures is substituted with materials or merchandise.

Automatic replenishment (AR) is an integral part of any QR programme. AR can be defined as an exchange relationship in which the supplier replenishes or restocks inventory based upon actual product usage and stock-level information provided by the retail buyer. AR therefore provides the final customer (consumer) with the desired product and service in a timely fashion. The goal of AR is to manage inventory levels effectively. With AR, as already indicated, information is substituted for inventory or merchandise.[4]

THE EFFICIENT CONSUMER RESPONSE (ECR) SYSTEM

Efficient consumer response (ECR) was developed for the grocery industry and is based on the same principles as QR. ECR calls for the creation of a timely, accurate and paperless flow of information. It relies heavily on electronic data interchange (EDI) and strategic alliances between supply-chain members. The goal of ECR is to eliminate costs such as inventory-holding and ordering costs in an entire supply chain. The underlying objectives are to reduce cycle time (time from placing the order to receiving the goods) in the supply chain, reduce inventories, avoid duplications in logistics costs and increase customer service.[5]

15.4.4The selection and management of suppliers

15.4.4.1The importance of selecting the right suppliers

Effective purchasing and supply rely on the selection of the right suppliers, particularly in the supply of strategic materials or services. As a result, the selection of suppliers is one of the most vital tasks of the purchasing and supply function. Competitive prices, reliable quality, timely deliveries, technical support and good after-sales service are determined primarily by the choice of the right supplier. Hence, it is essential for the purchasing and supply function to proceed systematically and objectively in selecting suppliers.

An important consideration when making this choice is that a long-term relationship with suppliers of strategic products or services is necessary to ensure effective purchasing and supply at all times. Important elements of such a relationship are honesty, fairness and being straightforward.

15.4.4.2The selection process

Supplier selection is an ongoing process. Existing suppliers have to be constantly reconsidered with each new purchase, especially in view of changing circumstances and needs. Past performance of an existing supplier obviously counts a great deal in the selection process. However, the care taken in the selection process will be determined

by the scope of the transaction, the availability of materials, the strategic value of materials and whether they are standard, or custom made. Custom-made items are items for a specific purpose and are therefore not generally available in the market. Standard items, however, are freely available at more or less the same quality and price, and in this case the choice of suppliers is not particularly important.

The process starts with the compilation of a list of suppliers that may be able to satisfy the need. The list can be compiled from various sources, including own supplier register, industrial advertisements, the Yellow Pages, trade guides, open tenders, shows and exhibitions. The list is then reduced to a shortlist, taking into account factors such as location, progressiveness, general reputation, and financial and technical ability. Suppliers on the shortlist are then requested to give a quote or negotiations are conducted with them. The aim is to obtain the best value (in respect of price, quality, service and delivery) for the business. The final choice of a supplier is based on considerations such as past performance, quality, price, delivery, technical support, progressiveness and reliability.

Once the choice has been made, the next step is the continuous evaluation of the performance of the supplier to ensure that it conforms to expectations. Unsatisfactory suppliers must be eliminated. The objective evaluation of supplier performance is important for the following reasons:

- Ineffective or unreliable suppliers are identified.
- It leads to an improvement in supplier performance.
- It serves as a guideline for the development of suppliers.

15.4.4.3 Developing suppliers

Purchasing and supply functions may become involved in the development of suppliers for various reasons. Suppliers may be developed for black economic empowerment purposes or to improve suppliers' performance as a result of performance appraisals, or if imported materials or services need to be replaced with locally made supplies (for example, the opening case study).

BLACK ECONOMIC EMPOWERMENT (BEE) THROUGH PURCHASING

In the spirit of reconstruction and development, and setting right inequalities, there is increasing pressure on South African businesses to give disadvantaged suppliers who show potential an opportunity to enter the market. Large organisations can help these suppliers develop, over time, into fully fledged independent suppliers. BEE purchasing and supply may be done in the following ways:

- Independent disadvantaged suppliers will benefit by lowering their quoted price by a certain percentage, just for the purpose of comparison with other quotations. The lower quotation normally gets the business. (This can be compared to the use of the handicap principle in golf).
- Specific pre-identified materials and services may be purchased from disadvantaged suppliers with potential, and such suppliers may be supported for adhering to the contract and executing orders.
- Support given to disadvantaged suppliers may be in the form of managerial and technical assistance, making facilities available, staff training and advancing operating capital.
- Products and services that were formerly produced by the business may be subcontracted or outsourced to disadvantaged suppliers. Management of a business may, for example, decide to sell catering services to employees in the cafeteria, which then functions as a separate business, rendering services on a contract basis.

- A certain preference percentage can be accorded when comparing prices to other suppliers who, in turn, commit to making a certain percentage of their purchases from suppliers (second-tier suppliers) from disadvantaged groups.

Example

At TFG Manufacturing, the manufacturing arm of Foschini, the physical manufacturing is done externally (thus outsourced) by 20–30 cut-make-and-trim operators (CMTs)(small manufacturing suppliers), some of whom work exclusively for the group. They are treated like an extension of the company. The best of the suppliers attend planning meetings, many are assisted financially to maintain their cash flow, and all have access to the group's textile testing laboratory and quality assurance, human resources and production planning departments. Some CMTs have been brought back from near bankruptcy through this approach. Normally, a retailer places an order with CMTs or suppliers, who then purchase the fabric and trim it themselves and mark up the final product accordingly, also taking into account their transport costs and finance charges. By playing banker to CMTs, TFG is able to further eliminate some of the traditional mark-ups in the supply chain. It is clear that for Foschini and specifically TFG, local supplier development is an important strategy.

Source: Adapted from Bisseker, C. 2014. The business of fashion. *Financial Mail*. Available at http://free.financialmail.co.za/07/0907/features/dfeat.htm.

MATERIALS OR SERVICE NOT AVAILABLE

If a firm has a need for a particular material or service that is not available in the market, it can enter into a contract with a chosen supplier of another material or service to manufacture this material (product) or provide this service. Assistance to such a supplier may be in the form of staff training, the reconstruction or expansion of facilities, or the implementation of new facilities. A joint venture can be formed with the supplier. In any case, a long-term agreement with the supplier would be a prerequisite.

Example

A new three-year textile cluster has been awarded to TFG (Foschini Group), in partnership with the Department of Trade and Industry. This textile cluster supports the apparel supply chain requirements for retail, namely the mill, the converter, the dyer, the printer and the factory. The establishment of this cluster will result in an even greater range of fabrics being converted locally. In addition, significant capital is being provided by TFG to specific supplier development opportunities with identified manufacturers in KZN. A large proportion of TFG's fabric is locally sourced from the KZN region. It has, therefore, become necessary to increase their value add by expanding their capability in this region to include fabric conversion, trim conversion, printing and assembly.

Source: TFG Integrated Report 2017. Available at http://tfg-integratedreport2017.co.za/downloads/.

NORMAL PERFORMANCE APPRAISAL

Normal performance appraisals can contribute to the development of suppliers by identifying their weaknesses and encouraging them to perform better. This is an important factor in establishing successful long-term ties with suppliers.

15.4.4.4 Long-term relationships with suppliers

The nature of the relationships that organisations have with their suppliers varies. Some relationships are distant, while other relationships are closer. An organisation will

have little involvement with suppliers of standard, easy-to-get products or services, but a great deal of involvement with suppliers of strategic and/or scarce materials or highly complicated, unique services. An alliance or a partnership is a high-involvement relationship. Attributes of strategic-supplier alliances are trust and co-operation, interdependence, joint quality-improvement efforts, information (and systems) sharing, risk and benefit sharing, and joint problem-solving.

15.4.5 Pricing decisions

15.4.5.1 The 'best' price

Price has traditionally been regarded as the decisive factor in awarding orders. However, low prices go hand in hand with higher costs in other areas. These include the costs and risks attached to low quality and high inventory, when low prices (as a result of quantity discounts) are linked to quantity. The right price is not necessarily the lowest one. The total or final costs should rather be seen as the decisive factor in awarding orders. In other words, price should be regarded as only one of the components of value, together with quality, delivery and cost of use. A buyer should always strive to obtain the highest value for the business.

On the one hand, the price paid for materials or services must be reasonable and should enable the purchasing enterprise to make its own product or service competitive in the market. On the other hand, a reasonable price should also be fair to the supplier to ensure that a supplier sells its materials or service at a price that will ensure its sustainability and survival. The price should therefore be fair to the purchasing firm and the supplier in terms of profitability and value.

15.4.5.2 Purchasing price determination

The methods used to determine purchasing prices depend on the nature of the materials and the value of the transaction. Published price lists and available market information, including catalogues, brochures and advertisements in trade journals, are most suitable for the purchase of standard materials and orders of a low monetary value (for example, when purchasing screws and stationery). Other methods of price determination are quotations and tenders (also called 'bids' or 'bidding'). When a business uses this method of price determination, it asks suppliers to make an offer. The purchaser sometimes calls for open tenders by publishing the invitation to tender. Any supplier can make an offer. The trend, however, is to issue a request to tender to a number of known suppliers. These 'closed tenders' are most suitable for purchasers with a complete list of suppliers.

Quotations are quick and informal. They can be made by telephone or electronically. Quotations are used when standard materials are purchased, but they are also suitable for non-standard or custom-made materials with a high monetary value (for example, custom-made equipment that performs a unique function). Tenders are accompanied by a drawn-out procedure that has to be followed to the letter. The modern trend is to limit the use of tenders to a minimum. Tenders are usually suitable for the purchase of infrastructure development, custom-made materials with a high monetary value, when there is plenty of time for the process and when there are many suppliers in the market in active and serious competition with each other (for example, in the construction of buildings).

Tenders and quotations are also used as a basis for post-tender negotiations. Post-tender negotiations take place between purchaser and tenderer/s if none of the tenders received is deemed acceptable, or where a supplier is chosen above another for certain reasons, but the price or other conditions are unacceptable. Negotiation often gives a

buyer the best results. However, successful negotiation requires careful preparation by an experienced negotiation team. Negotiation entails a personal meeting between buyer and seller with a view to reaching a compromise and concluding a deal. It is an expensive method that is justified only in transactions with a high monetary value, where contract conditions are complex, when the execution of the contract stretches over a long period and when business is conducted with the only suppliers in the market (a monopoly) or a supplier in a strong market position.

Although tenders and negotiations have been discussed as pricing methods, it is important to emphasise that they are also used to determine quality, service and delivery of purchased materials or services.

Critical thinking

Why were tenders used as a method of selecting suppliers and determining prices for the Gautrain project and the upgrading of the road network by SANRAL in Gauteng?

15.4.6Timing of purchases

15.4.6.1The 'right' time to buy

The time at which purchases are made often determines the price paid for materials. In the same way, time and price determine the quantity to be purchased.

The aims of buying at the right time are:

- to ensure that the business is supplied on an ongoing basis with the materials and services required for it to operate without interruptions;
- to reduce the risk of price fluctuations; and
- to keep inventory-holding at an optimal level.

To realise these aims, a buyer should have a sound knowledge of the market and trends.

15.4.6.2Factors influencing the scheduling of purchases

Various internal and external factors influence the time at which purchases (and obviously their quantity) should be made. Internally, business policy may prevent buyers from buying speculatively, so that they are unable to make use of bargain offers. Furthermore, the availability of funds in the business determines when products are purchased. Changes in the marketing and operations requirements may influence the time at which purchases are made because most purchases are made for these functions. Physical facilities such as storage space are another factor that influences the timing of purchases.

The first external factors to determine the time of purchases are market conditions (supply and demand) and government regulations. During recessions, there is a favourable buyers' market and materials can be bought at lower prices because of the decrease in demand for materials resulting from fewer economic activities. During these periods, it is advisable to buy large quantities of materials. Obviously, a business can benefit from such market conditions only if it has the necessary funds, and provided that its economic activities and demand for the final product or service are expected to increase. In a boom period, economic activities are high and the demand for suppliers' products increases. Prices increase and service to the purchaser tapers off. During such periods, it is wise to buy early at lower prices. Buyers should, as far as possible, avoid making purchases when prices are high. If the boom is expected to level out (prices are expected to decrease), it is wise to buy at the last minute (within the limits of lead times) and in small quantities.

Lead times and the reliability of suppliers are additional external factors that determine the timing of purchases. Government restrictions are another consideration in that they place limitations on organisations conducting business with foreign suppliers. A buyer in South Africa will, for example, have difficulty in obtaining permission to purchase materials overseas if South Africa's foreign money supply is limited or if local suppliers' continued existence is at risk (for example, the textile industry in South Africa).

Critical thinking

If petroleum companies in South Africa obtain information about a future meeting of crude-oil producers in the Middle East and expectations are that these producers will decrease their barrel output in order to increase prices, what will the South African companies do? What will the advantages and disadvantages of their action be?

15.5 Summary

The purchasing and supply function is an important one for the following reasons:

- It has a significant influence on the efficient operations of the business.
- It is often the greatest spender of business revenue.
- This function makes it possible for the business to sell its final products at competitive prices.
- The purchasing and supply function, like all other functions in the business, should be planned, organised and controlled to ensure that it helps to achieve the objectives of the business.

This chapter has provided some insight into the management of the purchasing and supply function.

The main purchasing activities of quality, quantity, price, supplier selection and timing were discussed.

It was emphasised that the different purchasing and supply activities do not occur in isolation, but on an integrated basis. The integration of the purchasing function with other functions of the business to enable the system to operate as a whole was also emphasised.

Small business perspective

Never before in the history South Africa has the small business sector featured so prominently. Small business is seen as the key to our country's economic development and particularly a creator of employment opportunities. In addition, the opportunities for small business development through policies and regulation instituted by the government, such as the Broad-Based Black Economic Empowerment Act (No. 46 of 2013) and its Code of Practice, have never been greater. One of the most prominent elements in the B-BBEE scorecard is the procurement element. Big organisations and government institutions are obligated to procure (purchase) goods, services and projects from small suppliers and especially become involved with the development of new or existing small suppliers. New changes to the BEE Code and particularly those to the 'Enterprise and Supplier Development' element, suggested by the Department of Trade and Industry in March 2018, makes this element more important than ever, to the advantage of small businesses.[2] As stated in Chapter 3 there is concern that not enough is done to support SMEs. Hopefully the new DTI initiative will improve the chances for growth for the small business sector in South Africa.

KEY TERMS	
automatic replenishment	planning
centralisation	post-tender negotiations
cross-functional sourcing	profit-leverage effect
decentralisation	published price lists
developing suppliers	purchasing and supply cycle
economic order quantity	purchasing and supply function
efficient consumer response	quick response
enterprise resource	quotations
fixed-order quantities	specifications
inventory management	speculative purchasing
inventory-carrying costs	standardisation
inventory-holding	supplier performance
inventory-ordering costs	suppliers
just-in-time	teams
materials-requirements planning	tenders
negotiations	

Questions for discussion

Reread the case study on pages 577 to 578 and answer the following questions:

1. Explain how Foschini has improved their competitiveness in the local clothing retail market.
2. Explain the importance of the purchasing and supply cycle for TFG.
3. List the steps in the purchasing cycle and use the case of TFG and Foschini as an example to explain the steps the business will follow when purchasing fashion goods/apparel.
4. Use the Foschini-TFG case study to explain and illustrate the disadvantages of holding too much and too little inventory.
5. Explain how implementation of quick-response (QR) and automatic-replenishment (AR) is being made possible in the Foschini-TFG group.

6.Explain what Foschini-TFG does to develop their suppliers.
7.Provide the reasons why Foschini-TFG is committed to developing local suppliers.
8.What benefit does the final consumer reap from the local supplier development drive that Foschini-TFG are implementing.

Multiple-choice questions

1.When an organisation purchases an important strategic item, which of the following qualities will it regard as most important when deciding on a supplier?
a.Price, quality and delivery
b.Location, cost and value
c.Financial stability, managerial and technical ability, and capacity
d.Technical ability and quality

2.Tender is the most suitable price determination method when …
a.purchasing standard product.
b.there is a number of possible suppliers of a complicated project.
c.there are two possible suppliers that will be able to compete.
d.the project does not need a close buyer-supplier relationship.

3.The activities of the purchasing and supply function should include ________.
i.the selection of suppliers.
ii.determining the quantity and quality of materials or services.
iii.deciding what prices to accept.
iv.expediting and receiving materials.
a.i
b.i, ii
c.i, ii, iii
d.i, ii, iii, iv

4.The purchasing and supply function would be able to buy the exact quantity of materials required at a certain time if all of the following criteria were met:
i.The operations function was 100 per cent certain of the quantity of materials to be used in the manufacturing process.
ii.The marketing function was 100 per cent certain about how many products were going to be sold.
iii.There were no supply problems in the supplier market.
iv.The incoming materials completely satisfied quality requirements.
a.i
b.i, ii
c.i, ii, iii
d.i, ii, iii, iv

5.The objective evaluation of supplier performance is important for the following reasons:

i.Ineffective or unreliable suppliers are identified.
ii.It leads to an improvement in supplier performance.
iii.It serves as a guideline for the development of suppliers.
iv.None of the above.
a.i
b.i, ii
c.i, ii, iii
d.iv

References

1.Baillie, P., Farmer, D., Crocker, B., Jessop, D. & Jones, D. 2008. *Purchasing principles and management*. Tenth edition. Essex: Prentice Hall (Pearson Education), p. 162.
2.Badenhorst-Weiss, JA., Cilliers, J.O., Dlamini, W. & Ambe, I.M. 2018. *Purchasing and supply management*. Seventh edition. Pretoria: Van Schaik.
3.Ibid., p. 45.
4.Badenhorst-Weiss J.A., Van Biljon, E.H.B. & Ambe, I.M. 2017. *Supply Chain Management:A balanced approach*. Pretoria: Van Schaik.
5.Ibid., pp. 350–352.
2.For more information on B-BBEE Codes and amendments visit DTI's website https://www.thedti.gov.za/editmedia.jsp?id=4415